BANK SALES OF MUTUAL FUNDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND DEPOSIT INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MARCH 8, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103–123

BANK SALES OF MUTUAL FUNDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND DEPOSIT INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND
URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MARCH 8, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103–123

U.S. GOVERNMENT PRINTING OFFICE

77–127 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044420-9

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HENRY B. GONZALEZ, Texas, *Chairman*

STEPHEN L. NEAL, North Carolina
JOHN J. LAFALCE, New York
BRUCE F. VENTO, Minnesota
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
JOSEPH P. KENNEDY II, Massachusetts
FLOYD H. FLAKE, New York
KWEISI MFUME, Maryland
MAXINE WATERS, California
LARRY LAROCCO, Idaho
BILL ORTON, Utah
JIM BACCHUS, Florida
HERBERT C. KLEIN, New Jersey
CAROLYN B. MALONEY, New York
PETER DEUTSCH, Florida
LUIS V. GUTIERREZ, Illinois
BOBBY L. RUSH, Illinois
LUCILLE ROYBAL-ALLARD, California
THOMAS M. BARRETT, Wisconsin
ELIZABETH FURSE, Oregon
NYDIA M. VELAZQUEZ, New York
ALBERT R. WYNN, Maryland
CLEO FIELDS, Louisiana
MELVIN WATT, North Carolina
MAURICE HINCHEY, New York
CALVIN M. DOOLEY, California
RON KLINK, Pennsylvania
ERIC FINGERHUT, Ohio

JAMES A. LEACH, Iowa
BILL McCOLLUM, Florida
MARGE ROUKEMA, New Jersey
DOUG BEREUTER, Nebraska
THOMAS J. RIDGE, Pennsylvania
TOBY ROTH, Wisconsin
ALFRED A. (AL) McCANDLESS, California
RICHARD H. BAKER, Louisiana
JIM NUSSLE, Iowa
CRAIG THOMAS, Wyoming
SAM JOHNSON, Texas
DEBORAH PRYCE, Ohio
JOHN LINDER, Georgia
JOE KNOLLENBERG, Michigan
RICK LAZIO, New York
ROD GRAMS, Minnesota
SPENCER BACHUS, Alabama
MIKE HUFFINGTON, California
MICHAEL CASTLE, Delaware
PETER KING, New York

BERNARD SANDERS, Vermont

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND DEPOSIT INSURANCE

STEPHEN L. NEAL, North Carolina, *Chairman*

JOHN J. LAFALCE, New York
BRUCE F. VENTO, Minnesota
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
JOSEPH P. KENNEDY II, Massachusetts
FLOYD H. FLAKE, New York
KWEISI MFUME, Maryland
LARRY LAROCCO, Idaho
BILL ORTON, Utah
JIM BACCHUS, Florida
MAXINE WATERS, California
HERBERT C. KLEIN, New Jersey
CAROLYN B. MALONEY, New York
PETER DEUTSCH, Florida
THOMAS M. BARRETT, Wisconsin
MAURICE HINCHEY, New York

BILL McCOLLUM, Florida
JAMES A. LEACH, Iowa
RICHARD H. BAKER, Louisiana
JIM NUSSLE, Iowa
CRAIG THOMAS, Wyoming
SAM JOHNSON, Texas
DEBORAH PRYCE, Ohio
JOHN LINDER, Georgia
RICK LAZIO, New York
ROD GRAMS, Minnesota
SPENCER BACHUS, Alabama
MICHAEL HUFFINGTON, California

CONTENTS

WITNESSES

TUESDAY, MARCH 8, 1994

APPENDIX

BANK SALES OF MUTUAL FUNDS

TUESDAY, MARCH 8, 1994

House of Representatives,
Subcommittee on Financial Institutions
Supervision, Regulation and Deposit Insurance,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Vento, Kennedy, LaRocco, Leach, Nussle, and Thomas.

Also present: Representative Neal of Massachusetts.

Chairman Neal. Let me call the subcommittee to order at this time.

I apologize for being late. I got caught in the traffic and couldn't help it. It is a pleasure to welcome all of you here this morning.

Today the subcommittee examines the sale of mutual funds by financial institutions. Banks, through their trust departments, have always been involved in mutual funds, using such funds for investment purposes, for trust assets, and serving as investment advisers to mutual funds. Today, however, banks and thrifts have increased their involvement with the retail sale of mutual funds in order to retain customers seeking higher returns on their deposits as well as to boost their income.

In fact, a recent American Bankers Association survey indicated that 43.8 percent of banks believe selling mutual funds is a high priority, and of those banks that are losing depositors, more than 65 percent said they are losing them to mutual funds.

According to one industry analyst, about 3,000 financial institutions sell mutual funds, and the sale of mutual funds through banks and thrifts totaled over $409 billion for the first half of 1992, the most recent figure available. This figure represents 33 percent of the mutual fund markets, total money market fund sales, and 14 percent of all stock and bond fund sales.

Financial institutions sell both shares in mutual funds managed by third-party entities and shares in their own in-house-sponsored funds known as proprietary funds. Approximately 150 financial institutions currently offer over 1,000 of these proprietary mutual funds.

According to one estimate, bank proprietary funds constitute one-third of all bank and thrift mutual fund sales and represent 10.7 percent of the overall mutual fund market, up from just over 8 percent of the market in 1992.

I believe that sales of mutual funds is a good thing for both banks and their customers, but it is important that we establish rules to make sure customers understand that mutual funds are not federally insured products. To that end, we will examine what the banks and the regulators are doing to ensure such customer knowledge.

Two recent consumer surveys highlight these concerns. The first, sponsored by the American Association of Retired Persons, the North American Securities Administration Association, and the Consumer Federation of America, indicated that 82 percent of financial institution customers did not understand that mutual funds sold by financial institutions are not federally insured, and that 52 percent of purchasers of mutual funds through financial institutions believed that these products were insured by the Federal Deposit Insurance Corporation.

The second survey, sponsored by the SEC, indicated that 30 percent of financial institution mutual fund customers believed that such funds were FDIC insured.

I am sure we all agree these numbers are unacceptable. In addition to the consumer issues, we must ensure that banks and thrifts structure their operations so as not to create unacceptable risk to the financial institution or to the FDIC.

In short, the subcommittee is holding this hearing to learn more about the involvement of banks and thrifts in the sale of mutual funds and what efforts are being made by Federal bank regulators and the financial industry to ensure that bank customers are adequately apprised of the risk involved in purchasing mutual funds and that banks and thrifts structure their mutual funds sales operation in a manner that protects the bank customer as well as the Federal deposit insurance funds. We will also examine whether legislation is needed to address these concerns.

In this regard, I have asked witnesses to provide their opinions on H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act, introduced by Chairman Gonzalez and Mr. Schumer. We will also receive testimony from Representative Neal of Massachusetts, the sponsor of Depository Institution Mutual Fund Sales Act.

We will first hear from our distinguished colleague, Representative Richard Neal, a former member of the subcommittee. We will next hear from the Honorable Andrew Hove, Jr., Acting Chairman of the Federal Deposit Insurance Corporation; the Honorable John LaWare, Governor, Board of Governors, Federal Reserve System; the Honorable Eugene Ludwig, Comptroller of the Currency, Office of the Comptroller of the Currency; and Mr. Jonathan Fiechter, Acting Director, Office of Thrift Supervision.

Our third panel consists of Mr. Scott Jones, chairman of the board and chief executive officer, Goodhue County National Bank, Red Wing, Minnesota; Mr. John Shivers, chairman, president, and chief executive officer of Southwest Bank, Fort Worth, Texas, representing the Independent Bankers Association of America; Mr. Ray Martin, chairman and chief executive officer, Coast Federal Bank, Los Angeles, California, representing the Savings and Community Bankers of America; Mr. Thomas Johnson, chief retail banking executive, Barnett Banks, Inc., Jacksonville, Florida, and

chairman, Consumer Investments Committee, Consumer Bankers Association; and Mr. Matthew P. Fink, president, Investment Company Institute, Washington, DC.

Our final panel consists of Mr. Chris Lewis, director of banking and housing policy, Consumer Federation of America; Mr. Phillip Feigin, securities commissioner of Colorado, and president-elect of the North American Securities Administrators Association; Ms. Tess Canja, member of the board of directors of the American Association of Retired Persons; and Ms. Diane Colasanto, president of Princeton Survey Research.

We have a lot to cover today, so I would appreciate it if all could summarize their testimony, giving us a little more time for questions and answers. Your complete written statements will, of course, be made a part of the record. We certainly look forward to hearing from all of you. And we would like to start out with our very distinguished former member of this subcommittee, my good friend, Rich Neal.

Rich, welcome. We would like to hear from you.

STATEMENT OF HON. RICHARD E. NEAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. NEAL OF MASSACHUSETTS. Thank you very much, Mr. Chairman.

First of all, I would like to commend you for holding this hearing on the sale of mutual funds. As banks continue to increase their sale of mutual funds, this hearing certainly is very timely. An impressive group of witnesses have been gathered to provide testimony on the regulation of the sales of mutual funds. Hopefully, this hearing can shed light on a solution that all of us can live with and a solution that will protect consumers.

In the last several months banks have increased their sale of mutual funds. For the first time in history, assets of mutual funds have exceeded assets of deposits.

With the continuation of low interest rates, many consumers are turning to mutual funds for a higher interest rate. More than one-third of all banks are now in the business of selling mutual funds.

As a former member of this subcommittee and the Committee on Banking, Finance and Urban Affairs, I have learned that deposit insurance is a confusing issue for many consumers. As we all know, deposits in federally insured depository institutions are covered for the first $100,000. This coverage is limited to certain types of accounts and deposits in different accounts in the same institution can be accumulated toward this amount. The concept is simple enough, but many consumers are confused by the extent and the scope of the coverage.

In the last few years, there have been several bank failures, particularly in New England. I have heard from numerous constituents who had more than $100,000 in their accounts. Several of these constituents were not aware of the $100,000 limit. Others were not aware that deposits in accounts in the same institution were accumulated toward the $100,000 limit. This leads many to believe that many depositors are not clear on which types of deposits are not covered by Federal deposit insurance.

I have been surprised by the number of consumers who believe any type of investment instrument from a depository institution is covered by the Federal depository institution. So many people walk into a bank and see the Federal Deposit Insurance Corporation seal in the window and feel that their money is completely protected.

A few years back this subcommittee had a very intense debate on the issue and scope of deposit insurance. The issue was limiting the coverage. Deposit insurance was established to protect individuals from bank failures. It was not established to protect sophisticated investors or risky investments.

My argument this morning is not to say mutual funds are a risky investment, but their protection was not the intent of the establishment of Federal deposit insurance. Mutual funds differ from a certificate of deposit and should not be guaranteed the same protection. Mutual funds are not covered by deposit insurance. This fact has to be made clear to all consumers.

Since banks have the protection of Federal deposit insurance, they have an obligation to their consumers to notify them of what products are covered by the deposit institution. If a bank wants to sell mutual funds, their employees should be trained in this area, and notification to the customer is important, that the product is not covered by deposit insurance.

In 1993, bank regulators issued four separate sets of guidelines and instructions for banks on the sale of mutual funds. The FDIC released a statement on this issue. The FDIC is concerned, rightly so, that depositors may confuse mutual funds with certificates of deposits.

Certificates of deposit up to the amount of $100,000 are covered by deposit insurance. Currently, mutual funds are sold without any disclosure that addresses deposit insurance. The sale of mutual funds is conducted in the same manner as accounts covered by deposit insurance. The FDIC has suggested that guidelines are needed in this area.

Recently, several banks have voluntarily let customers know mutual funds are not covered by deposit insurance. This was indeed an important step. However, I believe there should be legislation regulating the sale of mutual funds. I agree with the FDIC that guidelines are needed but I believe these guidelines should be mandatory.

Last fall I introduced House of Representatives bill 3389, the Depository Institution Mutual Fund Sales Act. This legislation places two requirements on depository institutions that are selling mutual funds. It amends the Federal Deposit Insurance Act to require that depository institutions notify customers who purchase mutual funds on the premises of the institution that mutual funds are not insured deposits.

The first requirement is an insured depository institution shall require any person who sells or offers for sale a mutual fund to disclose in writing to any person who seeks information about the sale of a mutual fund that they are not insured deposits. The second requirement is an insured depository institution should include in advertisements or promotional pamphlets the information that the mutual fund is not covered by depository insurance.

At the beginning of the year, the Nation's six banking trade associations prepared voluntary guidelines for bank retail sales of mutual funds and nondeposit investment products. The guidelines are intended to complement the guidelines released by bank regulators. They adequately address oral and written disclosures, advertising and promotion, location and training of employees.

This morning I would commend the trade associations for their efforts. I believe the guidelines are appropriate and would eliminate confusion among consumers. However, I am concerned that all institutions will not adhere to the guidelines. Once the sale of mutual funds fades from the limelight, banks may stop following the guidelines.

Sale of mutual funds by banks should not create additional paperwork for banks. However, if they want to sell this product, they should be required to notify the customer that mutual funds are not insured deposits.

H.R. 3389 simply requires banks to notify the customer in writing. After that point, it should be up to the customer to be responsible for their decisions.

Banks should be just required to be legally responsible for disclosing the information. I strongly agreed with the guidelines issued by the banking associations, but I believe the disclosure regulations need to be enacted into law. However, banks who sell mutual funds should adhere to all the guidelines from the trade associations and bank regulators as well.

I thank you for allowing me to testify before this subcommittee. I just want to close on one note, Mr. Chairman.

I served on this subcommittee and this full committee under some very painful days. And we have a tendency in this institution to suffer from collective amnesia. There was a great deal of pain and anguish that was caused to individual consumers across this country, including our representative congressional districts.

I bring this up to point out that much of what is passed off from time to time in political debate sometimes has little standing and sometimes great merit. We are all reminded about the foolishness of the December surprise, when all the banking institutions in the country were going to fail as soon as the Presidential election was over. I invite those who suggested it to look back, and the authors who wrote books about it, to pass off the demagoguery they did so effectively for the American people.

I want to cite one example of a woman who visited me, in her late sixties at the time. She had two children who were retarded. She came to my office with no desire whatsoever for the government to take care of her children. She had saved $157,000 all her life. Of that $157,000, she lost approximately $57,000. When she came to us she suggested she never had any understanding that deposits above $100,000 were not covered.

For this woman there weren't many shopping sprees in her life. There certainly weren't any big Saturday night dinners and there weren't a lot of picnics or joy. She decided she was going to adequately take care of these children. She wanted to leave something behind when she moved on so these children would be covered.

I bring that up today to point out that these are real issues with real people, and there is real devastation that is from time to time

caused in their lives. I simply would ask that we all collectively revisit FIRREA, FDICIA, and all those others that were so painful for us at the time and to give the consumer a very simple instrument; that is, to alert them to the fact that mutual funds are not covered by the Federal Deposit Insurance Corporation.

I thank you, Mr. Chairman. And this Congress will be diminished without your presence, I want you to know that.

[The prepared statement of Mr. Neal of Massachusetts can be found in the appendix.]

Chairman NEAL. Thank you.

You are saying that you think there ought to be a signed statement, when a person invests——

Mr. NEAL OF MASSACHUSETTS. In mutual funds.

Chairman NEAL. In a mutual fund, to the effect that that person understands that the investment in that fund is not covered by the Federal deposit insurance.

Mr. NEAL OF MASSACHUSETTS. That is the essence of it. It creates no onerous bureaucracy. The banks complain about new regulation and paperwork, and I don't think this does anything of the sort, but it does provide the consumer, I think, with real protection.

Chairman NEAL. I think it probably would provide the bank with protection also, because they would have this written documentation that deposit insurance doesn't cover it. It would seem of some help. I know it may not be the final word.

But let me ask you also, now, there are several ways of accomplishing this, as you suggested in your comments. It could be accomplished through industry agreement to do this. It could be accomplished by regulation. Or it could be accomplished through legislation.

You suggested legislation, I know, but if the regulators were to require this, would that satisfy——

Mr. NEAL OF MASSACHUSETTS. I would subscribe to the theory that the regulators could indeed accomplish the same goal. I would just suggest that, once again, we have a tendency here to focus on the future. We have a tendency to focus through the news media on what is new and what is next. That tends to claim much of our time in this arena of debate.

The difficulty is that there is always the risk that the regulators may well not take this issue with the same enthusiasm that we do at the moment, because we are all reminded of those simple people like the woman I made reference to who sat across from my desk in Springfield and simply made the case that everything she had planned for in life was out the window.

And that is the only suggestion I have, that we just rekindle that memory and the thoughts that went into developing the plan.

Chairman NEAL. I appreciate the gentleman bringing this to our attention.

Mr. Leach, do you have any questions at this time?

Mr. LaRocco.

Mr. LAROCCO. Welcome back to the subcommittee, Rich. What is the difference between——

Mr. NEAL OF MASSACHUSETTS. I am only visiting.

Mr. LAROCCO. You would be somewhere very close to the chairman.

Mr. NEAL OF MASSACHUSETTS. I would be sitting next to the chairman.

Mr. LAROCCO. What is the difference between your legislation and the Gonzalez-Schumer proposal?

Mr. NEAL OF MASSACHUSETTS. I think, obviously, the Gonzalez-Schumer proposal is more encompassing. It deals with a host of ancillary issues as well. My legislation is fairly simple. I do think the banks make some legitimate arguments about paperwork, and the burden that we often create for them in the stampede of public opinion. And I understand that the issue of competitiveness for the banks is very important, and I did learn some lessons here that some might interpret as being supportive of the banking institution.

But I do think in the end our primary obligation here is to protect the consumer, and this simple instrument I proposed would do that adequately.

Mr. LAROCCO. Would your legislation be retrospective for people who purchased funds in the past? Would the banks be obligated to notify them that the holdings that they have or the purchases they made——

Mr. NEAL OF MASSACHUSETTS. No, it is not retrospective.

Mr. LAROCCO. It would be prospective?

Mr. NEAL OF MASSACHUSETTS. Yes. But I think, as is always the case, the amount of debate that takes place oftentimes focuses on those issues, and I think the banks would develop an instrument fairly quickly to compensate for any delay.

Mr. LAROCCO. You mentioned the word "training" in your testimony. Does your bill deal with any mandatory training——

Mr. NEAL OF MASSACHUSETTS. It recommends it. I think it is a good idea. I think that competition in the marketplace may well take care of part of that.

Mr. LAROCCO. Good to see you.

Mr. NEAL OF MASSACHUSETTS. Nice to see you, Larry.

Mr. LAROCCO. Thank you, Mr. Chairman.

Chairman NEAL. Rich, thank you very much for coming in this morning. We welcome your future thoughts on this. Thanks a lot.

Our next panel is comprised of the Honorable Andrew Hove, Jr., Chairman of the Federal Deposit Insurance Corporation; the Honorable John LaWare, Governor, Board of Governors, Federal Reserve System; the Honorable Eugene Ludwig, Comptroller of the Currency; Mr. Jonathan Fiechter, Acting Director, Office of Thrift Supervision.

Unless there is objection, we will hear from you all in the order in which I mentioned your name. If that is all right, we will do that. I would ask you all to keep your statements reasonably brief so we can have a little time for dialog, if that is possible.

Mr. Hove, we would like to hear from you.

STATEMENT OF HON. ANDREW HOVE, JR., ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. HOVE. Thank you, Mr. Chairman and members of the subcommittee.

I am pleased to have this opportunity to testify on bank sales of mutual funds. We believe this is a timely subject, and commend your efforts to develop the public record on this important issue.

By earlier agreement, my opening statement will review the supervisory statement on mutual fund sales issued by the regulators in October. And for this reason, my oral statement will be slightly longer than the other panelists.

Sales of nondeposit investment products on bank premises are not something that is new to FDIC-supervised institutions. For instance, the savings bank life insurance programs in Connecticut, New York, and Massachusetts long have included the sales of annuities, and discount brokerage services have been offered by some banks for a number of years.

Banks have also been involved in securities transactions through trust department activities and have operated common trust funds for customer accounts. The sale of commercial paper and "retail repos" on bank premises has received close scrutiny for years. These services and products have been offered without any detrimental effect on the financial condition of the banks and with minimal consumer complaint.

The FDIC has had in place since 1984 section 337.4 of its rules and regulations which deals with securities activities of subsidiaries of insured nonmember banks and banking transactions with affiliated securities companies. The regulations establish operating rules for banks having such subsidiaries, including disclosure provisions and controls over intercompany transactions.

Bank retail sales of mutual funds have grown considerably in recent years. We estimate that at least one-third of the banks which FDIC supervises have involvement in sales of nondeposit investment products. Bank involvement in the sale of mutual funds is a part of the continuing evolution of the delivery of these products in this country.

Any industry that is undergoing rapid change must be monitored carefully since rapid growth is sometimes accompanied by lapses, abusive practices, or programs that outgrow management's capabilities. The familiarity of the bank surroundings can give customers both the sense of security to inquire about products which may be unfamiliar to them as well as a false sense of security about the safety of their investments.

The Federal financial institution regulators have issued to banks and bank examiners substantive guidance on the standards and procedures for prudent bank involvement in the sale of nondeposit products and for identifying and correcting abuses. The banking industry itself has issued guidelines for self-policing. However, an important question remains as to how banking agency supervision of bank sales of mutual funds interfaces with traditional securities industry supervision.

Both bank and securities regulators are concerned that the customer be protected from abusive practices, and that expansion of the financial products offered by banks not be bogged down in duplicative supervision and regulation.

Recent surveys and reports indicate that the degree of confusion among consumers with respect to bank sales of mutual funds is unacceptably high. This confusion is due in part to the failure of some

banks to follow the best practices and guidance provided by the regulators and banking trade groups.

For this reason, the FDIC will launch three new initiatives. As I will describe in more detail, the FDIC will prepare and distribute a plain English brochure describing and discussing the distinctions between FDIC insured and uninsured bank products, require all persons selling mutual funds to be subject to the same training and examination requirements as nonbank sellers of mutual funds, and initiate a testing program.

The FDIC concerns about bank sales of mutual funds are in two major areas: Customer confusion and management of the Sales Program. The FDIC and other bank regulatory agencies have issued guidelines to address these concerns.

On October 8, 1993, the FDIC issued a "Supervisory Statement Regarding State Non-member Bank Sales of Mutual Funds and Annuities." Other agencies issued similar statements to the institutions they supervise. The statement served as guidance to State nonmember banks relating to FDIC's concerns about bank sales of mutual funds and annuities. Our examiners have been examining for compliance with these guidelines.

On February 19, 1994, we joined with the Office of Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve Board in issuing an "Interagency Statement on Retail Sales of Nondeposit Investment Products." This superseded our original statement. Both statements advise banks to develop policies and practices to address specified supervisory concerns we have outlined.

The guidelines serve as notice to bankers as to what, in the opinion of the regulators, constitutes safe and sound practices with respect to mutual fund sales. If, for example, bank employees misrepresent the safety of the investment or mislead customers to believe that the mutual fund is insured by the FDIC, such misrepresentation constitutes an unsafe and unsound practice, and under section 8 of the FDI Act, the institution could be subject to a broad array of enforcement powers and civil money penalties. In addition, the regulators can also enforce banks' compliance with any laws and regulations with regard to securities.

To counter customer confusion, the financial institutions regulators have stated in our guidance that banks engaged in sales of nondeposit investment products should disclose to the customer that the product is not insured by the FDIC, is not a deposit or other obligation of the institution, is not guaranteed by the institution, and is subject to investment risks, including possible loss of the principal invested.

We believe that these disclosures, given orally during sales presentations and when investment advice is provided, and in writing prior to or at the time an investment account is opened, can help reduce customer misconceptions concerning who is ultimately liable if there is a loss in the investment. Appropriate disclosures should also appear in periodic statements to customers.

Advertising and other promotional materials about nondeposit investment products should conspicuously include the appropriate disclosures. Any advertising or promotional material by third-party vendors on bank premises should clearly identify the company sell-

ing the nondeposit investment product and should not suggest that the depository institution is the seller if it is not.

We are also concerned that the customer be informed of any advisory relationship that a bank has with a particular mutual fund.

The regulators expect these disclosures to be clear, concise, and conspicuous. We have found banks and their trade associations to be quite supportive of this effort. Our examination experience since the implementation of the supervisory guidance indicates that most banks have been conscientious in attempting to ensure that customers purchasing nondeposit investment products receive appropriate disclosures. Where our examiners have found deficiencies, banks have taken steps to correct these problems.

Although we consider disclosure to be the centerpiece in any program to eliminate customer confusion, we also have taken strong positions concerning the setting and circumstances in which the sale of nondeposit investment products should occur on a bank's premises. We believe that having a physically distinct sales area for nondeposit investments is necessary in order to deter customer confusion.

We expect banks to develop and implement policies that ensure the purchasers of nondeposit investment products are not lured by false, incomplete, or misleading promotions. Once in the bank, the physical location of the sale should be distinguished in a manner that causes a customer to recognize that they are considering something other than a traditional deposit or bank product.

Our guidance also addresses concerns about the personnel selling these nondeposit products. Whether the salesperson works for the bank, is a dual employee of the bank and a third-party broker/dealer, or is in the bank representing a third-party broker/dealer, the person must have received adequate training relative to the products being sold. Employees who are representing third-party vendors should clearly inform customers for whom they are working.

Because of the significant possibility for customer confusion, tellers should not be involved in selling investment products or offering investment advice. The bank should train all the customer contact persons, even those who are not involved in the sales of nondeposit investments, to make sure they understand the bank's policy. That policy must limit employees who are not authorized to sell investment products to referring customer inquiries to trained sales representatives.

While customer confusion issues have received much public attention, we are also concerned with the bank's management and administration of its Nondeposit Investment Sales Program. Banks involved in the sales of nondeposit investment products should adopt policies and procedures for their sales program, including establishing qualitative standards for the selection and review of each type of product sold or recommended. We also expect that banks will conduct an appropriate review of any third party who may contract with the bank to offer these products to the bank's customers.

In addition to ensuring that appropriate products are offered and vendors meet the bank's standards, any program to sell nondeposit investment products should be designed to ensure that the products offered are suitable for the individual customer's needs.

Banks' compensation programs should not compromise an employee's judgment of a product's suitability by providing greater compensation when an unsuitable product is sold. A properly structured nondeposit investment product sales program can benefit not only the customer, through convenient locations at which to shop, but also the bank which may be able to forge stronger bonds with its customers by meeting more of their financial needs.

The FDIC is not content, however, with the actions taken to date and will continue to actively monitor bank sales of mutual funds. Despite our efforts so far, it appears that there continues to be customer confusion. We are committed to ensuring that no bank exploits the confusion that often confronts consumers when they purchase financial products.

We will be preparing an FDIC-approved and authorized brochure describing and discussing the distinctions between FDIC insured and uninsured bank products in clear language. The brochure will be made widely available directly to consumers and we will direct bank sellers of mutual funds and other nondeposit products to provide it to customers as part of their disclosure material.

We also believe that all persons selling mutual funds should be subject to the same training and examination requirements—whether they work for a bank or not. We, therefore, will be exploring with the SEC and the NASD, as well as the other banking regulators, how that can be accomplished.

Finally, the FDIC will commission a formal on-site testing program. Under this program, we will use testers to see what institutions are actually telling customers in sales presentations and in response to inquiries. This program will serve two purposes in that it will provide us with information regarding any systemic problems as well as triggering corrective action in any cases where we discover a problem.

In addition, the three Federal banking agencies have adopted changes to the bank call reports and also the OTS has modified their thrift report to identify banks that are involved in the sales of mutual funds and annuities, the dollar volume of their sales by product type, and the contribution these sales activities make to bank earnings.

This sales and income information will be used in the supervisory process to alert examiners and others at an early stage to significant changes in the bank's operations. These changes will be implemented for the first time as of March 31, 1994 call reports.

At this time we believe that the financial institution regulators are taking action that will be effective in providing a framework for the sale of mutual funds on bank premises which can provide consumers with adequate information and protection as well as limit the bank's liability and thus the exposure to the deposit insurance funds. We believe that the new initiatives that we are announcing today will also provide additional protection to consumers in identifying remaining problems.

Our written statement includes additional comments regarding H.R. 3306.

This concludes my formal testimony. I would be pleased to respond to your questions.

[The prepared statement of Mr. Andrew Hove can be found in the appendix.]

Chairman NEAL. Thank you very much.

Now we will hear from the Honorable John LaWare.

STATEMENT OF HON. JOHN P. LaWARE, GOVERNOR, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. LAWARE. Mr. Chairman, I am here today to describe the actions the Board has taken to regulate bank sales of mutual funds and to present the Board's views on what additional regulatory or congressional action is necessary.

There is no doubt that there is potential for confusion when mutual funds are sold to the public by depository institutions. The chief concern is that depositors may not understand that the mutual fund investments they buy from a depository institution are not deposits, and are not covered by FDIC insurance.

There is also the possibility that depository institution customers who buy mutual funds may receive less than adequate investment advice about mutual funds if sales personnel are not properly trained or their sales practices are not properly supervised.

It is equally clear that these potential abuses involving mutual fund sales can adversely affect the safety and soundness of a depository institution. If depositories suffer losses on investments they have purchased from a depository institution, the institution's reputation and possibly its financial condition could be adversely affected.

More specifically, litigation risk and possible deposit withdrawals could affect the bank unfavorably.

The Board takes these concerns very seriously. In supervising State member banks and the nonbanking activities of bank holding companies over the years, the Board and its staff have issued a number of interpretive opinions, supervisory letters, and informal staff opinions addressing issues related to sales of nondeposit investment products, including mutual funds. All of these statements reflect the Board's longstanding policy that when banks sell nondeposit investment products to their customers, they should do so in a manner that clearly distinguishes these products from insured deposits.

Chairman Hove has already described the provisions of the interagency guidelines. We believe the issuance of a joint agency statement is indicative of the concern of the agencies regarding the sale of nondeposit investment products by banks, or on the premises of banks.

I would like to briefly discuss the additional actions the Board and its staff are taking.

The Federal Reserve is augmenting its current examination procedures regarding sales of mutual funds by State member banks or affiliated broker/dealers to assure that the guidance contained in the recent interagency statement is being heeded. Bank sales of mutual funds traditionally have been supervised and examined by the Federal Reserve in the same manner as sales of other securities and nondeposit financial products.

Over the years, the Board's staff has developed product-specific examination procedures to ensure that these activities are carried

out in a safe and sound manner. Federal Reserve examiners have been reviewing on a regular basis the sales practices associated with nondeposit investment products for compliance with our policies.

The Board's staff has assembled an interdistrict task force composed of senior examiners who have experience supervising and examining brokerage affiliates of banks and bank holding companies. That task force has been revising and expanding the Board's existing securities examination procedures to incorporate the interagency statement.

Currently, the task force is field testing and refining the expanded procedures at an examination of a large regional bank holding company and its securities affiliate which is actively involved in sales of mutual funds on the subsidiary bank's premises. Upon completion of the examination within the next several weeks, the task force will assemble in Washington to confirm the revised mutual fund deposit procedures, which will be implemented immediately thereafter.

To avoid unnecessary regulatory burden on the banks and affiliated broker/dealers, the Board initiated discussions with the NASD to coordinate examination efforts. These initiatives include examiner support and possible information sharing regarding bank affiliated broker/dealers.

As part of this program, an NASD examiner went on-site with our examiner task force in field testing our mutual fund examination procedures. Aside from new examination initiatives, the Board's staff also is considering expanding the scope of the consumer education seminars now being offered by the Federal Reserve Banks around the country to specifically address consumer issues related to mutual funds.

The Board and its staff intend to closely monitor bank implementation of the interagency guidelines and any other developments in this area. With regard to possible congressional action regarding mutual fund activities by banking organizations, the fact that the substantive provisions of H.R. 3306 are essentially mirrored in the agency's guidelines reduces the need for legislation at this time. If a depository institution or any of its employees does not follow the guidelines, the regulators have ample authority to address any unsafe and unsound practices regarding the sale of mutual funds by depository institutions and to impose sanctions where appropriate.

The issues raised by this hearing today are of extreme importance to both consumers who are faced with increasingly complex choices about investments and savings, and banks who must address their customers' need for access to a variety of investment and savings vehicles.

Saving for a college education or for retirement is no longer as simple as depositing a set amount in a bank account each week. We believe that banks are in a unique position to help customers understand the choices before them, but banks must recognize and affirmatively address the potential for customer confusion, and need to provide consumers with complete and accurate information.

We intend to take all actions within our power to ensure that the depository institutions are subject to the Board's jurisdiction and do so.

Thank you, Mr. Chairman. I will be glad to answer questions at the appropriate time.

[The prepared statement of Mr. LaWare can be found in the appendix.]

Chairman NEAL. Thank you very much.

The Honorable Eugene Ludwig.

STATEMENT OF HON. EUGENE LUDWIG, COMPTROLLER OF THE CURRENCY

Mr. LUDWIG. Thank you, Mr. Chairman. I am pleased to be here to testify on the issues related to bank sales of mutual funds. You are to be commended for your efforts to focus public attention on these issues.

I have a detailed written statement that discusses bank sales of mutual funds. In the interest of time, I would like to submit the written statement for the record and focus my discussion this morning on what I have done for the last 11 months to create a regulatory environment for bank mutual fund sales that protects and promotes the interests of the consumer.

Bank trust departments have acted as investment advisors, transfer agents, and custodians for mutual funds for decades. Retail sales of proprietary mutual funds were sanctioned and underway long before I became Comptroller. In recent years, however, this area of bank activity has seen rapid growth. More than 150 banks, national banks, and State member banks, State nonmember banks, now offer their own proprietary mutual funds. The net assets of proprietary bank funds doubled between 1989 and 1991 and doubled again between 1991 and 1993, reaching $200 billion in 1993. Bank sales of third-party mutual funds, those managed by firms outside the banking industry, also have grown rapidly. These third-party funds account for roughly half of all bank mutual fund sales.

This growth in bank mutual fund activity raises new issues for bank regulation, from both a safety and soundness perspective, and from the perspective of consumer protection. Since I took office last April, I worked hard to address those issues through a series of actions. Many of those actions have yet to bear fruit. Some are bearing fruit already.

In particular, I am working toward accomplishing five objectives. First, to make sure that banks remain within the law as they offer mutual funds to the public. Second, to make sure that customers understand that mutual fund shares purchased from banks are not federally insured. Third, to make sure that banks handle their mutual fund operations in a way that does not threaten the safety of the bank or pose undue risk to the bank insurance fund. Fourth, to make sure that banks address potential conflicts of interest. And fifth, to make sure that we, the regulators, have the resources to respond to further sales growth in investment products going forward.

To advance these objectives, we have over the last 11 months taken several specific steps. One, within 3 months of my arrival at the OCC, we published detailed guidelines governing the retail sale of mutual funds and other nondeposit investment products by

banks. This guidance emphasized consumer protection, particularly meaningful disclosure.

Two, we organized a working group of all Federal regulators of banks and thrifts to develop interagency guidelines on bank retail sales of mutual funds, guidelines that the agencies released jointly last month.

Three, I urged industry leaders to find a way for banks and thrifts to police themselves in this area, and have repeatedly addressed industry groups on this topic. Partly as a result of this effort, the bank trade associations for the first time adopted joint retail investment product sales guidelines last month.

Four, we have developed a program of mutual fund examinations and have issued new examination procedures to assure that national banks comply with our guidelines. We have devoted substantial time and effort to developing the mechanism for systematic supervision and examination aimed specifically at bank mutual fund activities.

Five, we are working with the SEC in a variety of ways, including investigations and enforcement actions, information-sharing, and periodic staff meetings on policy issues. Further, we have joined the SEC in a research effort based on a comprehensive survey of households to improve our understanding of why some consumers are confused when they purchase mutual fund shares and to learn what kinds of disclosures work best in addressing this confusion. Through the use of focus groups in the first phase of this research, we are already gaining important insights into this issue.

Six, we have published a brochure entitled "Deposits and Investments: There's a Critical Difference," to alert bank customers to the risk of nondeposit products sold by banks. We are distributing this brochure through the Consumer Information Center. We believe that more than 1 million copies of this brochure have now been printed.

Mr. Chairman, my efforts in this area reflect my personal commitment to keep the OCC at the forefront of bank supervision in general and to protect the consumer in particular. I have spent the last 11 months working to mobilize the OCC, the Federal banking regulatory establishment, and the banking industry itself to address the supervisory and consumer protection issues raised by the growing volume of bank mutual fund activity. We are making progress. But we still have far to go. I am fully committed to this effort and am confident that in cooperation with the SEC, my fellow bank and thrift regulators, and the industry and consumer leadership, we will overcome the challenges we face in this area.

Thank you. I welcome your questions.

[The prepared statement of Mr. Ludwig can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

And our final witness on this panel is the Honorable Jonathan Fiechter. We would like to hear from you, please, sir.

STATEMENT OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. FIECHTER. Thank you, Mr. Chairman, members of the subcommittee. I appreciate the opportunity to present the views of the

Office of Thrift Supervision on the sales by savings associations of mutual funds and other nondeposit investment products.

As the fourth regulatory witness this morning, much of the substance of my testimony has already been covered by the previous three panel members. I will try not to repeat too much what you have already heard this morning.

The subject of today's hearings—the sale of mutual funds by banks and thrifts—highlights the continuing blurring of distinctions among our various financial institutions for stepped-up sales of nondeposit investment products such as mutual funds in an effort to retain customer relationships and over the longer run to generate fee income.

These activities are not without risk, both to the insured depository institution and to the customers who purchase these products. The objective of OTS policies and regulations is to reduce customer confusion and preserve safety and soundness in an effective and cost-efficient manner.

In my statement today, I would like to summarize: First, the risks that arise when savings associations offer uninsured investment products; and, second, the steps we have taken to minimize these risks.

The key issue is the risk of customer confusion. Consumer surveys conducted over the years have found that the public has incorrectly believed that money market mutual funds that hold government securities and offer check writing services are federally insured. Recent surveys suggest that the potential for such confusion increases when the products are sold through depository institutions. Customers purchasing investment products in depository institutions are more likely to view the product offered in the institution as being safe or insured.

A survey released in November 1993 by the SEC highlighted this public confusion. The survey revealed that of 1,000 households surveyed, a full 36 percent responded that mutual funds purchased from a stockbroker are federally insured.

Let me emphasize that this misunderstanding related to funds purchased from a stockbroker, not a bank or a thrift. When asked if they thought money market mutual funds sold through a bank were insured, 49 percent or an additional 13 percent responded yes.

While the survey was crude, it suggests that: First, a significant minority of the public is generally confused over whether or not mutual funds are federally insured; and, second, it suggests that such confusion seems to increase when, A, the product is similar to a traditional bank product, and B, when it is purchased through a depository institution.

Customers also frequently do not understand the financial risks presented by the product. The public's risk of loss of principal from an investment in a mutual fund is substantially higher than his or her risk from a certificate of deposit. The risk of loss also varies among types of funds.

Customers may not ask or be advised about the risk of loss in the investment. They may be uncertain whether the investment is appropriate for their needs. Certain vulnerable segments of the population may be specially targeted during marketing. While this

is an effective marketing tool, it may contribute to the likelihood of confusion and inappropriate investment decisions.

Unfortunately, the risk of confusion may be greater when the customer purchases the mutual fund through a bank or thrift rather than through the mail or from a broker. It is because of these risks that OTS has imposed a comprehensive regulatory regime consisting of several important components.

First, thrifts and their affiliates that engage in the sale of uninsured products are subject to the Federal securities laws. OTS-supervised thrifts, unlike banks, are not exempt from the definitions of broker and dealer under the Federal securities laws. As a result, all thrift employees selling mutual funds are registered representatives working for registered broker/dealers.

All of the requirements that govern broker/dealer and investment-adviser activities apply to thrifts and their affiliates that advise or sell mutual funds. As a result, thrifts that engage in uninsured product sales do so indirectly, either through service corporations or through leasing arrangements with third-party broker/dealers.

The OTS has service corporation regulations governing the sale of nondeposit investment products. These regulations include an extensive list of safeguards. For example, sales activities must be conducted in an area of the thrift's office separate and distinct from the deposit-taking areas. Tellers may refer customers to the separate brokerage area but are not permitted to be involved in any other way with investment product sales.

The OTS also has separate regulations governing the sale in the offices of a savings association of securities issued by that savings association or its affiliates. These rules include prohibitions on compensation, common sales areas, and fraudulent or misleading advertising.

The rules also require that customers sign a form certifying that they have received a copy of an offering circular and are aware that the security is not a deposit insured by the FDIC.

Finally, the OTS joined with the other Federal banking agencies in the recent issuance of the interagency statement on retail sales of nondeposit investment products. While we believe that mutual fund sales by banks and thrifts provide a benefit to both the public and to the industry, we recognize that to obtain the goals of minimizing customer confusion, further improvements to our regulatory and supervisory scheme are required.

We have stepped up our supervisory efforts with respect to the sale of uninsured products in order to keep pace with the increased sales activity that is taking place. The OTS has begun to collect information about thrift mutual fund and annuity sales activities for each calendar quarter.

We also track consumer complaints regarding uninsured products sold on the premises of savings associations. During 1993, OTS received two consumer complaints about this activity. With the increase in fund sales, we anticipate that the number of complaints will increase in the future. We have, therefore, altered our internal consumer complaint tracking system to specifically identify these types of complaints.

You have asked for comments on H.R. 3306. OTS supports the goals and objectives of this bill. In fact, many of the safeguards outlined in the bill are already mandated by the OTS.

I have outlined in my written testimony provisions of H.R. 3306 that are not presently incorporated into OTS rules. We would support an interagency effort to further explore these issues through a public notice and comment proceeding.

In conclusion, as the financial services industry becomes more homogenous, I believe that thrifts should be encouraged to remain competitive and be permitted to pursue business strategies that balance their primary reliance on the cyclical housing market. I also believe it is critical for this to be accomplished in a safe and sound manner.

The sale of nondeposit investment products by thrifts and their affiliates is presently subject to a panoply of regulations and supervision, under the Federal securities laws and through OTS regulation and the other measures I have described. We believe the existing structure reduces the risks that accompany these activities to an acceptable, manageable level.

We intend to closely monitor this area, and would be happy to work with this subcommittee to address concerns as they arise.

Thank you.

[The prepared statement of Mr. Fiechter can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

I am just wondering, it seems in listening to you, maybe I missed something, but Mr. Fiechter—I am just wondering, is all that necessary? Is it really necessary, although I can certainly understand a very serious concern about any institution selling any kind of instrument that it itself issues.

Mr. FIECHTER. The proprietary fund, or their own securities?

Chairman NEAL. Well, especially their own securities. I am thinking back to the situation with Mr. Keating, where people clearly thought they were getting something that they weren't. I mean, I can almost see an absolute prohibition on that sort of thing. But regarding everything else you are doing, is all that necessary?

I don't have a lot of personal experience in this area, but it is a general feeling that any person that buys a mutual fund from a mutual fund company does not expect a lot of investment advice, nor does one expect the person who handles that mutual fund to know what is appropriate for me or for anyone else.

I mean, it just seems to me—I am really asking, I must say, it seems to me that maybe we are going even too far. The idea of banks selling mutual funds is, it seems to me, a good one. It allows them to offer another service that the public benefits from competition. We are getting more competition in this area, more services, and it gives the bank an opportunity to earn some fee income, and very little risk. I can't see any risk to the bank, frankly, at all.

As far as the consumer goes, there are literally thousands, I guess, of mutual funds now. So it is not that the consumer couldn't buy mutual funds somewhere else if it was not available at the bank. I guess as long as it was made clear to a customer of a bank or savings institution that the mutual fund or—of course, that is

the subject of this hearing, but annuity or anything else, isn't federally insured, that that ought to be about enough. I mean, if that message really gets across.

I guess one worry is that that message might be somehow denied by some oral statement of an unscrupulous bank; that is to say, maybe there would be a written statement that said, "This mutual fund isn't federally insured," but then some employee said, "Oh, yes, that is just a formality, it really is, no one ever loses money on these things," and so on. Obviously, we have to guard against that. But if the person was adequately informed that the product was not federally insured, shouldn't that be enough? That is really my question.

Mr. FIECHTER. I think that is 85 or 90 percent of it. I did not mean to suggest that if you came into an S&L and said, I want to buy this fund, that the suitability requirements would be triggered. I think for thrifts and broker/dealers it is triggered when we attempt to sell—when we come to you and say, we have a product for you. But you can call up on the telephone and buy a fund from Merrill Lynch without any of the suitability requirements being triggered.

The reason that our regulations are more extensive than that of the banking agencies is a function of our not being exempt from the SEC rulings. I don't know why thrifts are not exempt vis-a-vis banks. We have not received, to the best of my knowledge, during the last several years of regulatory burden hearings, this has not been pointed out as an issue by the thrifts in terms of excessive burden.

The real issue, I think, is the customer confusion. And as I pointed out, there have been surveys that have suggested that people buying mutual funds from Merrill Lynch are as confused over their insurance status as they are from buying mutual funds from banks and thrifts. The public seems to think that the U.S. Government mutual fund with a check-writing feature on a bank, they tend to think it is insured regardless of where they buy it, and how we address the kind of really very simple English marketing that is required to make certain that the lady who gets $150,000 deposit at their bank recognizes it is insured up to $100,000. You can't walk in a bank without having a sticker on the window that I think tells you that. I don't know what more we can do.

That is the focus, I think, of much of what we have to do. It won't take 35 pages of regulations to get that fundamental concept across.

Chairman NEAL. You raise an interesting point. Did the surveys that we mentioned earlier indicate also that people thought that investments in money market funds and others with check-writing privileges and so on, even though not purchased through a bank, were federally insured?

Mr. FIECHTER. The survey that I referred to, which was a November 1993 SEC Commission survey, yes, the first question was: Do you think mutual funds that you buy at a stockbroker are insured, and as I remember, the number, 39 percent of the public said yes, and it had nothing to do with the bank-thrift issue.

I would be happy to submit for the record——

Chairman NEAL. These other surveys that we quoted——

Mr. FIECHTER. I am sorry. The question was: Are mutual funds purchased from a stockbroker federally insured? Thirty-six percent of the public said yes.

Chairman NEAL. I was surprised, too, when Congressman Neal testified that a person wasn't aware that the deposit insurance stopped at $100,000, because I thought that was so commonly known.

Mr. FIECHTER. We all deal with it a lot in our business.

Chairman NEAL. There is so much information bombarding people. And I know several of you commented—or, Mr. Hove, you did, that you thought there ought to be separate areas for the sale of these products.

Again, I guess my question is if that doesn't go a little too far. I don't quite understand why that should be necessary. If there is a full disclosure that it is not an insured product, and if investment advice isn't being given, why should that be done at a separate place?

Mr. HOVE. I think it is important that the customer know the distinction between the insured deposit and be separate from the teller line. Clearly, the tellers are not going to be selling the mutual funds at the same time they are taking insured deposits. So that is the distinction I think we want to make very clear, that it is a different location, so you are not walking up to the same window or the same person to make a deposit that you do to buy a mutual fund.

And I think that is the distinction that it is a distinct, different arrangement for the purchase, that it doesn't necessarily have to be a separate office, it doesn't have to be segregated, but it does make it very clear that there is a distinction between the insured deposit and the mutual fund.

Chairman NEAL. Well, there again, this is not something I know a lot about, but I have this picture of banks with a lot of branches in small areas trying to offer a wide range of services, and a requirement like this might just make it impractical for them to do so. I really don't know how many banks operate that way, but I just think that that is the way a lot of banks operate.

And if you require them to have separate employees to do the separate functions, it would seem to me to reduce their efficiency, and inhibit the ability of consumers to get these other services.

Mr. HOVE. I agree with you. I am somewhat familiar with smaller banks and branches in rural areas, and I agree with you that we don't want to put a requirement that you have to have a separate individual that only sells nondeposit products as opposed to someone that does. But I think we need to make the distinction very clear, because it is somewhat clear from the confusion we have seen and the anecdotes that we have heard about and that we have read about in the media, that there is confusion. I think we want to clear up that confusion so you are not going to the same window to buy a CD as you do for a mutual fund. It may be a desk over at the side. That person may be doing other things that are bank related. But that person clearly is responsible for mutual funds, so that the person that comes to the teller and talks to the teller and says, "Tell me about some of these other products that you are of-

fering," they can go see someone different than the teller that they walked up to.

Chairman NEAL. You also suggested that the employee ought to be so well-trained that he or she would know what is suitable for the customer. How would an employee know that? How would an employee of a bank know what is suitable for me or for you or for anyone else?

Mr. HOVE. Again, I would refer to what Mr. Fiechter had indicated. That really relates to the situation where the bank is aggressively trying to sell you a product. For example, you have a certificate of deposit that renews and before I suggest to you that you really ought to take that certificate of deposit and turn it into a mutual fund, I really need to know something about your needs and the reasons why you have that certificate of deposit, rather than just simply offering that kind of a product to everyone that comes in.

Clearly, there are different needs for different people. And if the individual approaches me and asks about the product, that is a different story than if I am aggressively trying to turn your CD into a mutual fund. And I think in that case, then I need to know more about your reasons for a nondeposit product.

Chairman NEAL. Again, maybe I am being too picky on this, isn't that what business does all the time, is constantly trying to sell us stuff? Personally, I don't want most of it. There again, no one else decides that for me. I have got to decide that for myself, don't I?

I can't see how the TV salesman or a car salesman should know whether it is suitable for me to buy that car or not. I don't see why we would treat some other product differently. Why does the mutual fund salesman have to know what is suitable for me and a car salesman not? What is the difference?

Mr. HOVE. I would agree with you. What we see in some of the anecdotes that we have heard about are that some people who have had CDs and that are elderly people that are interested in income and preservation of their capital have been encouraged to turn those CDs into mutual funds. And I think that is not appropriate. And really what we are talking about is for those people that clearly it is not an appropriate investment, that the individual ought to be conscious of their needs as to why they need a CD or a mutual fund or an annuity or whatever it is, but not to simply sell that person a nondeposit product because it is more advantageous for me as a seller than it is for them as a buyer.

Chairman NEAL. Is it typically more advantageous for an institution to sell a mutual fund than to have a person put money, a like amount of money in a CD, for example? Is it a more profitable situation?

Mr. HOVE. Not necessarily. But when they——

Chairman NEAL. Then why——

Mr. HOVE. When they do that, they are going from an insured product into an uninsured product. And, clearly, the public has a great deal of confidence in banks, and they have confidence in the people that they are talking to in banks, and therefore if that individual is suggesting something other than an insured deposit, there ought to be a good, rational reason why they would do that. Again, they have that great confidence in the bank and in the banker.

Chairman NEAL. You are really worried about the confidence in the banking system as much as anything here, it sounds to me. This is the point you are making now, whether it is the whole point or not.

Mr. HOVE. The point I am making now is that most banks and most bankers do an excellent job of referring their customers to the right kind of products that they sell. But there are some abuses and I think the anecdotes we have read about have pointed out some of those abuses, where some people have been put into products that may not be appropriate for their particular situation. And I think we want to prevent that, and therefore we have said that the individual that is selling them needs to know a little bit about what that person's financial requirements are.

Chairman NEAL. You are saying that is more important that that be done in a bank than, say, in an automobile dealership, where the dealer might try to sell a person a car that he couldn't afford. You are saying that it is more important in a bank that a salesman not try to do that than in an automobile dealership, and I gather it is because the confidence in the bank is more important. Is that——

Mr. HOVE. I think it is very clear that the confidence in the bank is very important. Whether it is more important in a bank or in a car dealership, I don't know. What we are talking about is an individual who has an amount of money that they are relying on for their income, in the case that I have cited.

I think we need to make certain that they are not putting people's money who have been in CDs into an uninsured product without the individual knowing full well that it is an uninsured product, that if they do that, there is the risk of loss of principal——

Chairman NEAL. But that can be done with a statement, without the person having the capability to determine what is suitable for that person, couldn't it?

Mr. HOVE. I agree.

Chairman NEAL. I don't mean to beat a dead horse here, but I just have a little trouble.

Governor LaWare, what would you say about this?

Mr. LAWARE. I think there is something of consumer psychology involved here. The relationship of an individual to his bank is very different, I would submit to you, without being pejorative in the comments, than the relationship with an automobile dealer. There is a certain amount of suspicion that the dealer is trying to put something over on the consumer. But that doesn't exist automatically in dealing with a bank. The consumer has a trusting relationship with his banker. And for the last 60 years, consumers' attitudes toward banks have been closely tied to the idea that their deposits are insured and protected by the U.S. Government.

Now, that is a combination that perhaps makes the consumer more susceptible. If he doesn't get good advice he is more likely to be susceptible at the bank than somewhere else. That is what we are trying to guard against. The question of the appropriateness of the investment is particularly important if the advice is coming from the banker because of that trusting relationship.

Chairman NEAL. So you agree there ought to be a separate person, a separate area?

Mr. LAWARE. Certainly, the preference is for a well-trained person who can elicit from the customer why he needs to make this investment and how much risk he can really afford to take, so that the advice or the suggestion about the investment option is fitted to that particular customer's needs, and I think that that can best be done by a thoroughly trained person.

It doesn't mean the person has to do that activity exclusively, but it should be a thoroughly trained person who is by virtue of his physical location in the bank not automatically associated with a teller and with the sticker by every teller's window that says "your deposits are insured." I think it is kind of as simple as that.

Chairman NEAL. Do you all agree on this point?

Mr. LUDWIG. Yes.

Mr. FIECHTER. Yes.

Chairman NEAL. Mr. LaRocco.

Mr. LAROCCO. Thank you, Mr. Chairman.

I think this is a good discussion about suitability. As a former stockbroker, I understand this issue. If this had a hint of being a Whitewater hearing, there would be a lot of people here today but this, too, is very important. I am happy to have you all here today.

I am concerned about safety and soundness. And, Comptroller Ludwig, I am convinced that you are going to be relentless in pursuing this issue.

Do you support legislation or do you feel you can handle this as you are now doing, through regulation and examinations, brochures, information disclosures?

Mr. LUDWIG. I am very sympathetic to congressional concerns in this area. This is an area, as I have indicated, that we take very seriously. At the same time, we believe that it is an evolving area. We think we have sufficient guidance and enforcement tools as well as a sufficient mandate in terms of our underlying statutory support, to do the job. We don't believe that legislation is necessary at this time.

Mr. LAROCCO. I tend to think that because of the importance of this issue, the way you have been pursuing this issue in the last year, that the witnesses feel that perhaps there is a train wreck waiting to happen with a 300- or 400-point drop in the market, a drop in the bond market, and that there is lots of confusion out there, and that there are going to be lots of lawsuits, lots of consumer complaints, if the customers' principal had eroded at some point. And how would you respond, Comptroller Ludwig, to that?

Mr. LUDWIG. I think this is a genuine problem, but it is not a crisis. This doesn't mean we are not serious, but it means we have to view it in perspective.

As financial services regulators, of course, we gloomily look for the potential for crisis all the time. That is our responsibility. In this situation, we have the time to proceed in a deliberative manner. This isn't an area that requires overkill. We want to take our rifle shots and get them right.

We are working hard to test best practices to find out what is, in fact, the most effective way to inform the consumer. I think it helps to target resources to get the maximum bang for the buck—both for the consumer and for the system as a whole.

Mr. LAROCCO. What is being done retrospectively? For example, have all the people who have purchased mutual funds through banks they received the brochures that have been put together by the ABA and the banks or by you.

Mr. LUDWIG. These are available to everybody. One of the reasons I have gone on the air and made speeches around the country is to try to inform everybody. Moreover, this year we have received 14 complaints from customers who had problems in the mutual funds area. Seven of the complaints—we followed up on all 14—7 of the complaints resulted in the bank unwinding the transaction. We are very much involved and care about customers who purchased mutual funds in the past. Nonetheless, we are moving ahead, trying to look to the future as well.

Mr. LAROCCO. I am concerned about the safety and soundness issue. I think if you look at the training and the location and the disclosures, the signing, I think all those things are important. Right now anybody that sells mutual funds normally has to take a series 6 examination, and under your regulations that would be put into place. Is that not correct?

Mr. LUDWIG. Under our guidance, training is necessary. We are concerned about suitability. We are concerned that the bank have proper policies and procedures regarding the way it conducts mutual fund activity. We want to be very careful about, and stay on top of, safety and soundness issues as well as customer disclosure.

Mr. LAROCCO. I think a lot hinges on suitability issues, Mr. Chairman. That is where a lot of lawsuits would have been filed had a severe market drop happened, because the issue is not only whether an investment is insured. There are issues with government securities funds, for example, and people ask: What is the base holding? Those aren't insured, but we all know that those are the safest investments, and that is where people buy investments after they go beyond $100,000 depository insurance. But what might be in the prospectus and what might be available to the fund manager is to short those, to hedge them, to buy futures contracts, although the base holdings could be treasuries.

Mutual funds, as we know, are not generic. We are talking about preservation of capital and the principals that investors have. So this is a consumer issue, because when people walk into those banks, they expect their capital will never be eroded, and if it ever is eroded because of a bank safety and soundness issue Federal deposit insurance will be there.

This is an important issue, and I think we have to decide on this subcommittee whether we should follow the course of legislation as an insurance policy, perhaps, against a train wreck. But I like the aggressiveness with which you are handling this and how forthright you have been, all of you, on this issue. I think it is critically important.

What is proposed on phone sales, if a customer is dealing with a bank?

Mr. LUDWIG. Under our interagency guidance, the person selling these funds must make the required disclosures and must treat the customer as if they were in the office. We are following up by checking those procedures in every national bank in the coming 12 months. We have detailed examination procedures which involve

checking the bank's procedures and whether the procedures are being followed, including disclosures in phone sales.

Mr. LaRocco. Thank you very much.

Thank you, Mr. Chairman.

Chairman Neal. Thank you, sir.

What amount does—one of your recommendations is to ensure that investment sales personnel are properly qualified and trained. Larry, you touched on that. What does that mean? How long does a training course take for someone to be properly qualified and trained?

Mr. Hove. I made the suggestion that the people that are selling in the banks have the same training and examination that a salesperson with a brokerage firm would have. That can be a short, concentrated course that is very intense, for a short period of time. I don't know specifically how long it would take. But it is not a long period of time to be qualified as Mr. LaRocco had mentioned in the particular series that it takes to sell mutual funds.

Mr. Ludwig. The interagency guidance requires training equivalent to NASD training. One of the reasons we didn't lock in a standard is that we believe the training is dependent upon what funds are being sold and what the bank's activities are.

Chairman Neal. That training period typically—would be what? If a person did it full time, would it be 2 or 3 weeks. Roughly, how long do you think it would take?

Mr. LaWare. I would suspect it is a little bit longer than that. The training has to cover not only product knowledge of the products that the person is going to sell, but operational aspects of how the securities are transferred and registered and so forth, sales and advertising limitations and opportunities and what you can say and what you can't say, compliance with all the regulatory issues that are either statutory or in the regulations, suitability—this whole thing we have just been talking about; finding out the right questions to ask the customer to determine what his situation is, and whether a particular product is suitable—and then some training in the ethical considerations that are involved, so that the thing is very straightforward and completely above board. It is the equivalent of the NASD training.

Chairman Neal. How long does that take?

Mr. LaWare. Honestly, I don't know how long it takes. I don't think you can compress it into a 2- or 3-week period.

Mr. Fiechter. The thrift staff do have to be NASD registered broker/dealers.

Chairman Neal. Do you know how long that takes?

Mr. Fiechter. Up to 2 weeks, I am told, for NASD.

Chairman Neal. Two weeks, full time?

When you all issued your joint statement on banks sales of mutual funds, you issued them as guidelines and not mandatory requirements. Why was that?

Mr. LaWare. I think guidelines are more flexible. And as we get experience with the application of the guidelines through our examination procedures, we will get some better idea of whether they need to be altered in order to make them more effective and more responsive to what our objective is.

Frankly, we would have the option at some point down the trail here of incorporating those guidelines into a regulation or series of regulations on this, and I don't think we need necessarily any additional statutory basis in order to do that. It can be done under the umbrella of the safety and soundness considerations.

Chairman NEAL. One other thing, then I will yield to Mr. Vento. Mr. LaRocco stated, briefly, the stock market has been great lately, and investors in mutual funds generally have done all right, but we know from history that there are likely to be corrections from time to time. So you have to bet that at some point there is going to be some downturn in the market—I hope it won't occur; I don't see any reason why it should right now—but at some point, if you just look at history, there is going to be some downturn in the market.

Now, if that happens, let's say we have done everything we can to adequately disclose to investors in mutual funds that that can happen, and we have signed statements and so on, what will be the reaction? Will people say, I really didn't understand? Even though we have gotten all these statements and made all these efforts, will confidence in the banking system be eroded? What do you all think? Have you had discussions about these questions? I am just curious.

Mr. LAWARE. If what we are proposing is done right, I think we can avoid most of that. There is always going to be somebody who has to lay off the responsibility for a personal failure on somebody else. Those people are always going to surface. But I think for the most part we can eliminate that as a general reaction if we do what we are proposing to do and do it well.

Chairman NEAL. Mr. Vento.

Mr. VENTO. Mr. Chairman, I apologize for being absent this morning, but I had another subcommittee hearing which I had to chair myself.

I commend the bank regulators who are here today for the work they have done on this topic. I think that given the restructuring that is going on, bank activities in mutual funds are an essential part of their services and portfolio and profitability, consumer convenience. Trying to define the regulatory responsibility and special responsibilities that are inherent to a bank or a financial institution is very important.

I know you are striving to do just that. Some I think would have us impose a disclaimer on the purchase of such investment to almost exclude the possibility of ever making a sale; their disclosure would be so onerous. And that is a problem.

There may be a special problem with banks in terms of making the transition especially from an investment where normally it is insured to one that is a mutual fund, or insurance or other activities which are not insured.

We know as a committee and as regulators who are responsible, there is not in fact FDIC insurance or any insurance for those sales. But is it sufficient to say that banks go as far as a broker, in terms of selling mutual funds? Because of the unique position of the bank, having insurance in the area, it is imperative that we really go beyond that level of the regular sales of the investment

banker to in fact avoid any possible confusion with regard to this issue.

Mr. Ludwig.

Mr. LUDWIG. In some ways, Congressman Vento, we go further. Our guidance specifically targets disclosure so as to prevent confusion about FDIC insurance. It is more detailed than guidance provided by registered broker/dealers. In a variety of other areas we have cross-referenced the requirements of the NASD so as to remain consistent.

The one area in which there is a distinction is training. The NASD gives tests, and we do not give those tests. We have requested that the NASD permit bank officers to take NASD tests, but thus far they have been resistant. We would certainly welcome help in encouraging the NASD to permit testing for bank officers who offer mutual funds. But we have encouraged banks to make sure that there is equivalent training and even to use some of the third-party providers of training services that are used by NASD registered broker/dealers.

Mr. VENTO. Then we will have tests for others selling banklike products. I expect, obviously, what we have here, is an effort to try and streamline the regulatory process, I am certain, that you can adequately regulate this.

The question is, of course, would there be an additional responsibility and a regulatory burden to in fact get the SEC involved directly in regulating—the sale by banks? The SEC in fact does regulate the instruments that are often sold. The banks are not doing underwriting, at least they are not supposed to be doing underwriting, with regards to paper that is sold in terms of mutual funds.

And so the SEC does have a regulatory function in terms of screening whatever the products that might be sold. Is that not correct?

Mr. LUDWIG. Yes, sir.

Mr. VENTO. So they already have a role. The question is, however, do they have to get into the bailiwick regulating banks? Obviously, the administration sees a regulatory structure that would be more definitive in terms of having a single financial institution regulator. That is obviously something that is being debated at this point.

But it would appear to me that there is a case for special regulation of a bank sale of mutual funds over and above the rigorous—already rigorous requirements of investment banking sale, and that, of course, should be carried out by whatever we determine is the financial institution regulator.

While making the case that it is special, asking someone to in fact sell this product by making a series of negative statements would really retard the ability to have this activity as a viable investment option at that bank. Such a rule therefore would preclude bank participation and cause them to have greater problems in terms of that profitability and being able to serve consumers well.

You have heard my two cents. Let me thank the chairman and the panel. I am sorry if I have repeated earlier issues that were raised.

Thank you, Mr. Chairman.

Chairman NEAL. Not at all. Thank you very much.

I would like to thank all of our witnesses who are helping us this morning. We may have some more questions to submit for the record, if that would be all right. If you have any further thoughts, we always welcome them. Thank you all very much for helping us this morning.

Our next panel is comprised of Mr. R. Scott Jones, chairman and CEO, Goodhue County National Bank, Red Wing, Minnesota, a member of the American Bankers Association Board of Directors; Mr. John Shivers, chairman, CEO, Southwest Bank, Fort Worth, Texas, representing the Independent Bankers Association of America; Mr. Ray Martin, chairman and CEO, Coast Federal Bank, Los Angeles, California, representing the Savings and Community Bankers of America; Mr. Thomas P. Johnson, chief retail banking executive, Barnett Banks, Inc., Jacksonville, Florida, and chairman, Consumer Investments Committee, Consumer Bankers Association; and Mr. Matthew P. Fink, president, Investment Company Institute

Mr. VENTO. Mr. Chairman, may I give a special greeting to my friend and fellow Minnesotan, R. Scott Jones with the Goodhue County National Bank in Red Wing, Minnesota. He actually is in Tim Penny's district, but I have come to know him the past several years in terms of working on a series of issues. He is a hard worker. He does represent a cross-section of Minnesota banks which are really a very sound and significant part of our community in the State. And I want to especially welcome him and look forward to reading his testimony and hope it somewhat parallels the comments that I made earlier in terms of financial institutions. But he and I have not talked about this subject, at least that I can recall, recently.

But I welcome him, as well as all the other witnesses that are here today representing banks across the Nation and various groups.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you. If there is no objection, we will hear from the panel in the order in which I introduced you. We will put your entire statements in the record. If you can summarize in about 5 minutes or so, it will help us have a little dialog and better understand this issue.

Thank you again for being here.

Mr. Jones, we will start out with you.

STATEMENT OF R. SCOTT JONES, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, GOODHUE COUNTY NATIONAL BANK, AND MEMBER OF THE AMERICAN BANKERS ASSOCIATION BOARD OF DIRECTORS

Mr. JONES. Thank you very much, Mr. Chairman.

And, Mr. Vento, thanks for the kind introduction.

My name is Scott Jones, and I am here representing the American Bankers Association.

Mr. Chairman, I commend you and your colleagues for holding these hearings, and I am delighted to be here today to discuss the issue of the sale of mutual funds by banks.

Most importantly, I wish to share with you some of the many efforts that the banking industry has undertaken to educate the

consumer concerning these investments. We believe that these efforts, in conjunction with the regulatory initiatives undertaken to date, obviate the need for legislative action in this area.

Our industry is taking extraordinary steps to both educate consumers and provide them with full disclosure. Do we as an industry still have work to do in our education and disclosure campaigns? Yes, we do. But we are committed to following through and doing so quickly.

However, I think it is important, especially in light of these hearings this morning, to make sure that all sectors of the financial services industry provide full information. We must ask what is going on in other financial service providers such as the securities brokers and insurance agents.

Recently, banks have been under the microscope. But as shown in advertisements contained in our written testimony, others in the financial services industry continue to mislead consumers apparently with little concern being expressed by the Federal regulators or the consumer groups.

The banking industry is truly undertaking a major consumer education and disclosure effort. ABA's efforts to inform customers about the uninsured status of mutual funds sold through banks have reached literally millions of people. And we are going to keep at it. Banks in the meantime are seeing millions of dollars flow out of their communities into institutions with no base in the communities and certainly no CRA requirements.

In many cases, consumer disclosures and practices in these institutions are no way comparable to bank practices. In fact, any bank doing these types of things would likely find itself in serious regulatory trouble.

For example, many bankers have seen customers go to brokers who leave the impression that the insurance provided by the Securities Investor Protection Corp., the SIPC, is much like that insurance provided by the FDIC.

On page 7 of our testimony is a blatantly misleading solicitation from a securities firm which shows just what we are talking about here. I do commend it to your reading.

Mr. Chairman, we bankers know that the new banking agency guidelines will be enforced by over 7,500 examiners. Again, we must ask ourselves, how many examiners will be looking at the sales practices of our competitors? Our joint goal should be to ensure that no consumer is misled and that all sellers of investment products are working together to that end.

The banking industry has refocused on ways it can improve. Specifically, the ABA, in partnership with five other trade associations, three of which are on this panel this morning, have developed a comprehensive industry guideline which I have with me today. That guideline covers the retail sales of mutual funds and other uninsured products. More than 25,000 copies of these guidelines have been distributed already, and we are about to go into another printing.

The cornerstone, of course, of the guidelines is customer disclosure, and the guidelines call for four basic disclosures. They are: First, that the investment is not a bank deposit; second, that it is not an obligation of or guaranteed by any bank; third, that it is not

insured or guaranteed by the FDIC; and fourth, of course, that it involves investment risk.

That disclosure must be clear and prominent. It must be included in all advertising and marketing materials.

I brought with me today an example of that kind of disclosure that is currently being used by a Wells Fargo bank. This same type of disclosure is being used by banks throughout the country, including ours, which makes these four disclosure points very clear to the customer. It sits on the desk of everyone that is selling these types of products.

In recognition of the fact that consumer education regarding mutual funds does not begin and end at the bank door, the ABA has undertaken a number of other initiatives aimed at educating consumers that mutual funds, no matter where they are sold, are not FDIC insured. Our October 1993 video news release has been viewed by an estimated 2.4 million television viewers. A similar news release tailored for radio has been heard by around 81,000 listeners around the country.

In addition, ABA has prepared an in-flight video announcement on mutual funds that aired on three airlines throughout the month of February. The estimate is that 3 million passengers viewed that announcement.

On February 1, 1994, the date that our trade association guidelines were published, a second ABA video release was sent out to 700 television stations around the country. ABA ran a national full-page consumer information advertisement on mutual funds on the February 1, 1994 issue of *U.S.A. Today*, and the identical advertisement will be running in the April issue of *Readers Digest*.

ABA has developed a consumer information brochure which clearly lays out the uninsured status and risk of mutual funds and has distributed almost 1 million of these brochures to member banks to make available to their customers. Other consumer-information initiatives are planned.

What I am saying, in sum, is that ABA is in the process of a major effort of reaching millions of people. In addition to this major effort on disclosure, our efforts also include a major commitment to training and the qualification of our employees. Under this ABA Program, employees of all banks in all regions of the country will be participating in a variety of courses and seminars on securities investments.

ABA, which represents over 90 percent of the bank assets nationwide, will continue to aggressively pursue our customer education and disclosure campaigns. We hope that our competitors will join us in this effort.

We believe that additional legislation and regulation is not warranted when we are working so conscientiously with the goals that we mutually share with you, our bank regulators, and our customers.

Thank you, and I welcome your questions.

[The prepared statement of Mr. R. Scott Jones can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Mr. Shivers.

STATEMENT OF JOHN SHIVERS, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SOUTHWEST BANK, REPRESENTING THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. SHIVERS. Mr. Chairman, Mr. Vento, I am John Shivers, chairman, president, and CEO of Southwest Bank in Fort Worth, Texas. I am also president of the Independent Bankers Association of America.

We greatly appreciate this opportunity to discuss banks' mutual funds sales and our efforts to provide full disclosure. It is very important that banks do this right. Investor and depositor protection is paramount.

To a large extent, community banks offer mutual funds for defensive reasons. They would much prefer their customers keep their funds in core deposits that can be used to support local economies. However, consumers can walk into a brokerage firm and receive traditional banking services such as checking accounts, debit cards, and loans. Offering mutual funds helps banks maintain key customer relationships.

Unnecessary restrictions on bank sales of mutual funds could effectively prohibit banks, particularly small banks, from selling mutual funds. This would hurt the consumers. To help those community banks that want to offer mutual funds to their customers and to do it right, the IBAA Community Banking Network has just launched a Mutual Fund Program.

Banks will use a consumer-friendly computer program, the Financial Asset Builder, to help their customers select the right investment products. A customer gathers information on his long and short-term goals and priorities, current financial situation, and risk tolerance. This information is entered into a program which then outlines a plan for the customer to meet his financial goals. The sales representative will recommend the appropriate mix of not only federally insured deposits but noninsured products to implement this plan.

For example, the program offers the well-established financial advice that families should have at least 6 months of emergency funds available in insured deposits before investing in noninsured products. All sales and promotional literature contains a prominently boxed disclosure making clear that mutual funds are not insured by the FDIC.

My own bank offers mutual funds, stocks, bonds, and annuities through a third-party broker that leases space in the bank. Since beginning last year, our program has provided a full range of investment and financial planning services to over 80 clients. Many have used our service to plan for their retirement.

Our provider operates under the close scrutiny of bank management. Each customer signs an acknowledgment making clear that brokerage services are not provided by the Southwest Bank and investments are not FDIC-insured.

Community banks have a particularly strong interest in making these disclosures since they know their customers and want to provide the best possible service.

The IBAA has joined with five other banking trade associations in developing joint guidelines for the sale of mutual funds and

other uninsured products. They are intended to ensure that bank customers understand that mutual funds and other investment products are not FDIC-insured.

Much has been made of a recent SEC survey of mutual fund customers that purported to show that most customers who bought mutual funds from banks were confused about whether they were federally insured. The SEC's conclusions were highly misleading.

Though the SEC surveyed 1,000 people nationwide, only 70 had bought their mutual funds through a bank. Of this tiny group, 46 thought that their money was federally insured. That is 46 too many.

But much more critical was the fact that over a third of those who had bought their mutual funds from a stockbroker also believed that they had Federal insurance. Clearly, the brokerage industry needs to provide better education.

Mutual funds companies are aggressively targeting bank CD customers with little interest in investor protection. Two recent advertisements demonstrate the significant problems. One claims that customers are safer with SIPC than with FDIC. Nothing could be further from the truth.

The second does not disclose that mutual fund investments involve the possible loss of principal. This disclosure must appear on all mutual fund materials that a bank gives to customers and in all advertisements. The SEC seems to be turning a blind eye to these practices.

In fact, the SEC has proposed a rule that would substantially add to the confusion by permitting mutual funds to make sales using only newspaper ads. These off-the-page prospectuses are clearly inadequate, containing none of the safeguards available to bank customers.

The banking industry and its regulators are building a good record. The IBAA strongly recommends that Congress give the agency and industry guidelines time to work. Customer education cannot be expected to be achieved overnight.

Legislative proposals that seem appropriate today could prove unworkable or ineffective in the future. Agency and industry guidelines can much more easily be adapted to changing circumstances or additional information.

We are particularly troubled by the location requirements in H.R. 3306. They could prohibit smaller banks from making mutual funds available to their customers because of space constraints.

The industry guidelines call for separation between mutual fund sales and retail deposit taking, but take into account the fact that many community banks operate out of offices that are just too small to provide separate rooms for mutual fund sales.

We are also concerned about language in H.R. 3306 that prohibits a person who accepts deposits from referring customers to a mutual fund representative. The bill's requirements are so technical and legalistic, a bank would almost have to instruct its tellers to deny that the bank offers mutual funds. The bill would be especially burdensome to a smaller bank where employees often wear several hats, including that of a teller. We fail to see anything sinister in tellers simply making a referral to a bank's investment center.

We strongly urge Congress to let the industry and agency guidelines work before passing new legislation. The banking industry has a vested interest in providing investor protection. Congress should not saddle us with burdensome new laws that would give our competitors an unfair advantage and drive customers away from banks.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Shivers can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Mr. Martin.

STATEMENT OF RAY MARTIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, COAST FEDERAL BANK, FSB, REPRESENTING THE SAVINGS AND COMMUNITY BANKERS OF AMERICA

Mr. MARTIN. My name is Ray Martin. I am the chief executive officer of Coast Federal Bank, headquartered in Los Angeles, California. Coast has $8.1 billion in assets and operates 88 branch offices throughout the State of California.

I am pleased to appear before the subcommittee on behalf of Savings and Community Bankers of America to comment on H.R. 3306 and the circumstances in which depository institutions sell uninsured products.

SCBA supports the ability of depository institutions to compete freely with nondepository institutions in offering uninsured products such as mutual funds and annuities to retail customers. In conducting these sales, it is essential that institutions adopt appropriate safeguards to ensure customer awareness of the risks as well as the returns from investing in these products.

Savings institutions are active participants in the marketplace for selling nondeposit investment products. Based on a survey of a sample of SCBA members, 17.5 percent sell mutual fund shares; 19.4 percent sell variable rate annuity products; and additionally, 14.8 percent of SCBA members provide brokerage of stocks and bonds.

Coast Federal Bank, through its subsidiary, Coast Investments and Insurance, makes nondeposit investment products conveniently available to its customers. Since 1988, Coast has covered fixed annuities to its customers and Coast customers have invested over $1 billion in fixed annuities.

In April 1993, Coast expanded its product line to include mutual funds. We offer a wide range of mutual fund and annuity investment products for our customers. These include 28 mutual funds and 2 annuity products.

SCBA and the other national banking trade associations developed guidelines to serve as the industry standard for the sale of mutual funds and other uninsured products by the Nation's banks and savings institutions. The guidelines were announced at a press conference on February 1. The guidelines are comprehensive, user-friendly, and consistent with the uniform interagency guidelines.

When SCBA sent the guidelines to each of its members, it strongly urged their adoption. Several SCBA initiatives are under way to help educate the consumer and help the industry implement effective uninsured products sales programs. SCBA is writing and

funding a consumer education column on the differences between investing in insured products and uninsured products such as mutual funds and annuities. The written Q&A spot will be sent to 10,000 small and midsized daily and weekly newspapers across the country for publication.

SCBA undertook to improve the usefulness of the pamphlet developed by the banking regulators to discuss the difference between bank accounts and uninsured investments. The goal was to make the pamphlet even more user-friendly for inclusion in mailings or on countertop displays.

We are cosponsoring a series of educational seminars for the members in six cities across the country in May and June on the topic of uninsured products. In addition, SCBA is offering sessions at two spring management conferences on the challenges and opportunities of offering uninsured products.

Our Flagship Graduate Program in Fairfield, Connecticut, thoroughly reviews the strategic financial compliance and service issues related to the sale of mutual funds. This 6-week senior-officer program with over 3,000 alumni has incorporated the industry guidelines on uninsured products and staff training requirements into its curriculum and case studies.

Institutions like Coast are in the process of evaluating the use of this customer followup program to verify that customers are properly informed on an ongoing basis. The options under consideration included a targeted call-back program, for periodic customer surveys. SCBA is monitoring industry efforts and will develop the model form an institution can use to periodically survey its customers on the effectiveness of its disclosures related to uninsured products.

SCBA has established a system via one of its subsidiaries whereby member institutions that are seeking to engage in sales of uninsured products as a new line of business can find the right type of third-party provider for a joint venture. A failure to ensure a meeting of the minds on marketing strategy could reduce the care with which such products are discussed with customers and generate unrealistic sales results from a particular customer base.

Also, SCBA has established access to a national computer data base containing full records of all enforcement actions taken by financial sector regulators against sales and management personnel. The data base covers depository institution regulators, the SEC and NASD, State securities, insurance regulators, and CFTC. Dial-up access to potential vendors is available.

Let me briefly turn to the proposed legislation. SCBA believes the most restrictive provisions in H.R. 3306 relate to: One, overly rigid specification on the location of uninsured product sales; two, on employees selling insured and uninsured products; three, excessive limitations on employee referrals and referrals compensation, and; four, on overly restrictive limitations on the use of customer limitation for marketing uninsured products.

In conclusion, in light of various initiatives under way in the industry and at both the associations and the regulatory agency, legislation at this time is unnecessary. Locking institutions into rigid, statutory procedures would reduce the need for flexibility of institu-

tions to periodically evaluate and modify their programs to best serve their customers.

SCBA is committed to doing its part in reviewing on an ongoing basis the progress of savings institutions in implementing the industry guidelines. SCBA would be pleased to share its finding with the subcommittee.

Mr. Chairman, that concludes my comments.

[The prepared statement of Mr. Martin can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Mr. Johnson.

STATEMENT OF THOMAS P. JOHNSON, CHIEF RETAIL BANKING EXECUTIVE, BARNETT BANKS, INC.; AND CHAIRMAN, CONSUMER INVESTMENTS COMMITTEE, CONSUMER BANKERS ASSOCIATION

Mr. JOHNSON. Good afternoon. Thank you, Mr. Chairman.

My name is Tom Johnson. I am the chief retail banking executive for Barnett Banks, Inc., Jacksonville, Florida. I am also chairman of the Consumer Investments Committee of the Consumer Bankers Association. I am pleased to appear before your subcommittee on behalf of the CBA and to testify on bank mutual fund activities.

I am here to discuss the involvement of the banking industry in the sale of mutual funds and the actions the banking industry has taken to assure adequate disclosure. The rapid growth of the mutual fund industry has highlighted concerns about the level of customer understanding about the uninsured nature and the risks of these investment products.

A number of surveys have been done which point out that there is some confusion about which products are federally insured. These surveys also show that this confusion is not confined to banks, but extends to all financial services companies. The banking industry has recognized a need for more consumer education in this area.

In an unprecedented effort, the CBA and five other bank trade associations have jointly developed comprehensive guidelines for depository institutions engaged in the retail sale of investment products. These guidelines are designed to complement the mutual fund guidelines developed by the Federal bank regulators.

In addition to these guidelines, other banking and securities laws apply. Further, bank regulators have extensive resources to monitor and enforce compliance with these laws. Therefore, additional legislation is not needed.

Without legislation, banks have established procedures to minimize confusion. I will give you a step-by-step process typically used by most banks.

When a customer in a bank office expresses an interest in mutual funds, the customer is referred to a trained and qualified investment specialist. The investment specialist verbally reviews the risks associated with mutual funds and discloses that the product is not FDIC insured.

If the customer is still interested, a profile is obtained of that customer and that information is used to assess whether a mutual

fund would be suitable for that particular customer. After this information has been carefully reviewed, the investment specialist may recommend a specific investment product.

At this point, the customer is given the prospectus for the specific mutual fund and that prospectus describes key features of the fund and provides information required by the SEC. The customer may place an order at this point.

The specialist then gives the customer a disclosure form to sign, and that form states that the customer is aware of the risks attached to the product and that the product is not insured by the FDIC.

Another review by trained supervisory personnel of the customer profile confirms whether the particular mutual fund is appropriate for the individual customer. If so, the order is entered, and that is followed then by a confirmation with disclosures. Periodic statements follow, including disclosures regarding the uninsured nature of the investment and its associated risks.

As you can see, a number of check points are built into the sales process to assure full disclosure. Consumers have turned to mutual funds because they provide access to professional money management. They are exposed to greater risks, but history shows over time the returns are better.

In conclusion, Mr. Chairman, I would like to say that the current financial services environment reflects that customers want the convenience of bank delivery channels in order to access professional money management. The CBA does not see a need for legislation at this time. Not only have the bank regulators recently acted, but because a host of other banking and securities laws apply. We believe that recent regulatory and industry efforts will result in better informed customers.

Thank you for this opportunity to testify on behalf of CBA. I will be happy to answer any questions at the appropriate time.

[The prepared statement of Mr. Johnson can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Our final witness is Mr. Fink.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman.

I am Matthew P. Fink, president of the Investment Company Institute, the national association of the mutual fund industry. Our members account for over 95 percent of total U.S. mutual fund assets and our members include over 800 bank-advised mutual funds which have over 80 percent of the assets of all mutual funds advised by banks.

Since the passage of the Investment Company Act of 1940, the mutual fund industry has experienced tremendous growth, from 68 funds in 1940 to over 4,500 mutual funds today, and from assets of $448 million in 1940 to over $2.1 trillion today.

There are many reasons for this success, but it is my view and the view of most people in our industry that the critical factor for the success of the mutual fund industry is the stringent regulatory

regime imposed upon mutual funds under the Federal securities laws.

In recent years, the role of banks in the fund industry has grown substantially. For example, in 1991–1992, commercial banks accounted for over 13 percent of total sales of long-term mutual funds. Mutual funds advised by banks now account for over $200 billion in mutual fund assets.

This growth in bank activity in the fund industry has been a positive development for the banking industry, for the mutual fund industry, and for the investing public. And we share with others here this morning the strong sense that banks should be permitted to engage in mutual fund activities in a way that enhances their prospects for success.

Nonetheless, mutual fund activities conducted by banks pose several important issues of public policy. First, we share the concerns of Congress, the Federal banking agencies, and the other witnesses today about the risk of confusion when investors purchase mutual fund shares or other noninsured products.

Therefore, the institute has undertaken a major public education program to ensure that customers of both banks and securities firms understand that mutual funds are not federally insured or guaranteed.

And I would commend the various bank trade associations who have undertaken similar types of educational programs.

Second, we are concerned that the sales practices of bank employees be sufficiently regulated. While many banks currently sell mutual fund shares through broker dealers, other banks sell mutual fund shares directly. Therefore, they are exempt from regulation by the SEC and National Association of Securities Dealers under the securities laws.

The guidelines that were issued by the banking agencies represent important interim steps to protect investors, but the ultimate responsibility for regulating all sales of mutual funds, including sales by banks, should be squarely vested in the SEC and the NASD.

Third, just as regulatory concerns arise when banks sell mutual funds, so do concerns arise when banks advise mutual funds. For example, bank mutual fund advisers currently are exempt from SEC regulation under the Investment Advisers Act, and similarly, for historical reasons, the Investment Company Act provisions do not address certain unique conflicts which can arise when banks advise mutual funds. These regulatory gaps are not addressed by current banking laws.

All of these issues reflect a single fundamental problem. Not all investors in bank-sold and bank-advised mutual funds enjoy the full range of protections characteristic of the mutual fund industry. And I assure you that this problem cannot be remedied by giving bank regulators oversight in this area.

Bank regulators have a very important mission, but it is quite different than the mission of the Securities and Exchange Commission. The overriding mandate of the banking regulators is ensuring bank safety and soundness, while that of the SEC is investor protection.

We recognize that mutual fund activities of banks may implicate bank safety and soundness, but in our view such risks as may arise will stem from the failure to subject bank mutual fund activities to full SEC oversight. Conversely, we believe that banks will be most likely to succeed in the mutual fund business if they are held to standards identical to those imposed on all other participants.

It is important to note historically the SEC has, over this 50 or 60 years, overseen the entry of new entrants into the mutual fund business. In 1940, when the Investment Company Act was passed, most mutual fund companies were mutual-fund-only firms or money management firms. In later years when broker/dealers, and then insurance companies sponsored mutual funds, the SEC regulated those new entrants into the business without sacrificing shareholder protection. SEC can do the same thing in the case of bank advised and sold mutual funds.

Our final concern relates to the fact that under current law, banks are unduly impeded from engaging in the mutual fund business.

The Glass-Steagall Act still bars banks from sponsoring and underwriting mutual funds, and it precludes, in section 32, bankers from serving on the boards of mutual funds. These impediments on bank mutual fund activity should be removed, and new impediments should not be created.

In particular, we believe that the establishment of a new redundant regulatory authority with duplicative and conflicting regulations would uniquely burden banks and reduce their long-term prospects for success in this market.

Precisely, these types of concerns about redundant and conflicting regulation are what has prompted the Clinton administration to propose the consolidation of the four principal bank agencies.

Thus, while we applaud the investor protection goals of H.R. 3306, we do not believe that Congress should promote the creation of a parallel universe of mutual fund regulators and regulations for banks. To do so, we believe, would elevate corporate form over substance, by subjecting banks that engage directly in mutual fund activities to one set of standards, established and enforced by banking regulators, while subjecting all other participants in the mutual fund industry, broker/dealers, insurance companies, investment advisors, and broker/dealers affiliated with banks to SEC and NASD regulation.

Thank you for this opportunity to testify. I would be happy to respond to any questions.

[The prepared statement of Mr. Matthew P. Fink can be found in the appendix.]

Chairman NEAL. Thank you, sir.

How do the SEC regulations concerning mutual fund sales differ from those suggested by the banking regulators?

Mr. FINK. In a number of respects, Mr. Chairman. First, let's take substantively, training. The NASD, the self-regulatory organization supervised by the SEC, says you can't sell mutual fund shares unless you take and pass a series 6 or series 7 exam. There is no parallel in the banking regulators.

Chairman NEAL. Their recommendation was to ensure that investment sales personnel are properly qualified and trained.

Mr. FINK. It is the difference between a hortatory statement, with all due respect to the banking regulators, and saying, This is a specific exam you must take.

Chairman NEAL. Let's say that is what they meant. I am trying to get at the——

Mr. FINK. I am trying to answer your question, Mr. Chairman.

Chairman NEAL. Let's say what they meant by "properly qualified" was the same thing you were talking about, in other words, passing this specific exam.

Mr. FINK. I will take that under—for the sake of discussion, I will take that. I don't think it does, in truthfulness.

Chairman NEAL. I didn't say it did; I said what if it did.

Mr. FINK. In addition, the SEC for many years has required special disclosure for money market funds, a certain type of disclosure that the fund is not insured and not guaranteed. The banking regulators require a different disclosure. So the disclosure differs in some respects, which is confusing to customers, most importantly, and also is a burden on the banks. We have had our bank members complain to us that they now face two sets of disclosure requirements.

Third, the NASD has a whole book of rules of fair practice—suitability, what you must tell customers, what you must get from customers, and so forth. It is a long, mini-essay booklet. The bank regulators say they are going to adopt something like that, come up with something like that. They really haven't, and it will differ again.

So, again, to go back, many of the banks in the business sell through SEC, NASD-registered broker/dealers. So they have to follow NASD, SEC suitability, training, qualifications. They are going to get a set of different regulations. I am not saying one is better or worse. But you are going to find two sets in each of these areas.

I have been trying to give you the substantive differences—most importantly, you have enforcement. Because it doesn't make a hoot and a holler what you write down if it is not enforced. The Federal securities laws give any investor the right to bring a private right of action. That doesn't exist under the banking laws.

The securities laws let you go to a self-regulatory organization if you think you have been aggrieved by a broker. You can go to the NASD or the New York Stock Exchange or the American Stock Exchange, and institute proceedings.

Most importantly, again, it is set forth in our written statement, under the investor securities laws, because investor protection is concerned, the SEC brings enforcement actions in the open, publishes names, gets consent decrees, cease and desist orders, or takes you to court. And it is all public. In the last year or so the SEC has brought 130 public enforcement actions in the securities area.

That is not the way banking regulators operate, because their mandate, as I said earlier, is mostly safety and soundness. So it would be curious to see a list of public bank regulator securities enforcement actions. Those are the differences. I am not saying one is better or worse. They come from two different cultures, two different mandates.

But I think when it is investor protection, the SEC regulates brokers, the SEC regulates insurance agents, the SEC regulates investment advisers, the SEC regulates financial planners, the SEC regulates broker/dealer subsidiaries of banks and it regulates thrifts, I believe. The one exception is when sales activities occur in banks, and now the proposal of banking regulators in this bill would erect a whole new set of substantive standards in that one case.

With all due respect, sir, I don't think that is the way investors will be protected.

Chairman NEAL. You say they have to register insurance sales?

Mr. FINK. Yes, they have to register as brokers.

Chairman NEAL. When they sell——

Mr. FINK. Annuities. If they are not fixed annuities. Variable annuities. Or they sell mutual fund shares.

Mr. VENTO. Mr. Chairman, a question for Mr. Fink. He mentioned 130 separate actions. Were those on mutual funds?

Mr. FINK. No, I think they are total, sir.

Mr. VENTO. It might be helpful to have a definitive answer. Obviously, 130 dealings with hundreds of billions of dollars, from trillions of dollars of transactions, how many were mutual funds?

Mr. FINK. Can I submit it for the record.

Mr. VENTO. How many are related to underwriting activities, and so forth, which cross the table here. I am sure someone would like to put it on the table. Mr. Fink, it would be helpful to have that.

Mr. FINK. I can submit that.

Chairman NEAL. The bank regulators do have a number of consumer protection responsibilities under CRA and fair lending practices, a whole range of things. I wanted to make the point that they are not limited to the safety and soundness areas of the bank, so they do have some experience and necessary interest in this area also.

The mutual funds themselves are already—and would continue to be—regulated by the SEC?

Mr. FINK. Yes. There are four laws implicated. The fund itself, whether it is bank or insurance or whatever, is regulated under the Investment Company Act, which is a detailed day-to-day statute.

Second, all mutual funds have to give prospectuses registered under the Securities Act of 1933. The place you find a discrepancy is in the Advisers Act, which regulates the person or firm who manages the mutual fund. It exempts banks. So all bank-advised funds are exempt from the Advisers Act.

Chairman NEAL. What is the practical effect of that?

Mr. FINK. The practical effect is the regulatory inability of the SEC to inspect the entire mutual fund complex. The SEC not only wants to see the fund's records, it wants to see the adviser's records, to find out if the adviser was selling it for its own account, or selling it for a pension account or otherwise disadvantaging the fund.

In fact, just 2 months ago, the SEC proceeded against a mutual fund group where the manager allegedly was trading for an in-house pension fund ahead of the fund. Because banks are exempt under the Advisers Act, the SEC cannot go into a bank and cannot test those activities.

The fourth act is the Securities Exchange Act of 1934, which regulates brokers and sales activities. Many banks sell not through the bank directly, but through a subsidiary or other affiliate of the bank.

In that case, that subsidiary or affiliate is registered with the SEC and is a member of the NASD and is subject to this whole body of 50–60-year-old law. But some banks sell directly through the bank, and are exempt from the Securities Exchange Act of 1934. It is precisely this unregulated sales problem that has touched off this debate.

Because there is that gap, the bank regulators have quite properly tried to fill it. I am saying there is a simpler way than creating a whole parallel sales practice system, and that is to say if banks sell mutual fund shares retail to you and me, they should register under the Securities Exchange Act and comply as bank broker/dealer subsidiaries with the Securities Exchange Act and SEC and NASD principles.

Chairman NEAL. That is fine. It is an interesting point. It is a point of view. You are saying that you think this group of regulators——

Mr. FINK. If I could give you the analogy, Mr. Chairman, we are having this merger of Dreyfus and Mellon. I think it would be crazy to say because Dreyfus is merging into Mellon we are going to have the SEC inspect Mellon's loan portfolio or CRA compliance. Instead, we recognize that such regulation is traditional banking regulation where we have 100 years of expertise in the Federal Reserve Board or the Comptroller of the Currency. That should not move to the SEC.

Now, I think it is equally crazy to say, now that Mellon has acquired Dreyfus, we are going to have the Comptroller of the Currency inspect the sales practices of the Mellon mutual funds.

Chairman NEAL. That is the point we are talking about.

Mr. FINK. That is the debate.

Chairman NEAL. I don't quite follow that analogy, either. The regulators take a look at all sorts of sales practices already that banks engage in as a part of what they do. They look at the way they deal with consumers under CRA and a number of other things that they do.

So the idea of them looking at the sales of another product is just simply not totally foreign to what they do already, it doesn't seem to me, especially considering the fact that the funds themselves, which is where we really got into the area of specialized expertise and experience and so on, are regulated by the SEC. And that wouldn't change under——

Mr. FINK. That is right. I think on sales—and it gets back to your question on suitability, sir, when you ask why is it treated differently than a car. When Franklin Roosevelt signed the Securities Act of 1933, he said we are changing the rules in the securities business from caveat emptor to caveat vendor. And that is the way the SEC works—that is why we have these 130-odd cases, because the SEC is very tough; the presumption is with the customer.

When banks are selling to rich trust customers or conducting private banking, I don't think they ought to be regulated by the SEC. But when banks are selling to the man and woman on the street

products like mutual funds, and you have an agency that Congress created 60 years ago to regulate consumer protection in securities, I would think——

Chairman NEAL. It wouldn't change.

Mr. FINK. I think——

Chairman NEAL. The mutual funds would still be——

Mr. FINK. But the sales practice——

Chairman NEAL. Well, I know.

Mr. FINK. The 1933 and 1934 acts concern sales practices, Mr. Chairman.

Chairman NEAL. You know, I am not—I must sound like I have already made up my mind. I haven't. I am just raising the question. I still don't see the answer.

Mr. Jones pointed out this ad that showed one of the brokerage houses asserting if you were unsatisfied with your bank insurance, you could just shift over to them and you would find your assets insured—not to $100,000 but to $500,000. And then you could also purchase another two billion dollars' worth and so on.

So I don't think this condemns the industry or anything like that. But I wonder, was there any complaint brought about this?

Mr. FINK. I might say three things, Mr. Chairman. It is a brokerage house, not a mutual fund.

Second, I was very bothered by the ad when I got the testimony yesterday. It is in two of the witnesses' testimony, and I think it is a very troublesome piece. I went out of my way to call the firm.

Chairman NEAL. What about previous action?

Mr. FINK. Pardon me?

Chairman NEAL. Had the SEC brought any action against this firm?

Mr. FINK. When I called up to express my own concern, I was told that the regulators had made the firm stop using it. It wasn't an ad, it was what they call a statement stuffer. But in any event, either the SEC or the NASD, has made the firm stop using the piece, an action which I think appropriate.

Chairman NEAL. Did they bring any other action against them?

Mr. FINK. That is all I know. That is all I know, sir.

Chairman NEAL. The only point I am making is, I don't think any regulatory agency is perfect, so——

Mr. FINK. Let me——

Chairman NEAL. The idea you say, well, you use this body because they have all this experience and they are great instead of this other body, I don't see the difference. I think they are both good. The SEC has done a good job, the Fed has done a good job, the Comptroller has done a good job, and so on. It is hard for me to see that argument, you have got to use one because they are so much better than the other. You can assert that. I just don't think you have proven that, is what I would say.

Mr. FINK. If I could just—on that, one of the issues here is not one or the other, but you have most of the banks are selling not through the bank, but through separate broker/dealer subsidiaries. And their biggest complaint to us is, "Look, we will take one or we will take the other, but on Tuesday, the SEC is in here, or the NASD, on Wednesday the Comptroller is in here, and they have different rules. We gave this disclosure, under SEC rules for 10

years, and now the Comptroller comes in and tells us that it is not good disclosure."

Chairman NEAL. So you are arguing against the duplication.

Mr. FINK. Yes, and I am making two arguments, sir. I would say duplication never makes much sense. Second, if I had to choose in the area of consumer protection, I would choose the SEC, although I probably have written more letters than almost anybody in the world attacking SEC actions over the years. I am hardly saying they are perfect. I am just saying it makes more sense to me to allocate that way.

Chairman NEAL. Is it a big issue with you that way? Is it very important to you that they do it? If you had a choice, you would say I would take this before the other one, or——

Mr. FINK. It is not life or death, but I think it would be a better thing for the consumer.

Chairman NEAL. Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman.

You asked, Mr. Fink, you are getting all the questions, but I am going to move along here to others, but the issue of citizen suits in the SEC, do you have any statistics to report to us how many citizen suits are actually brought?

Mr. FINK. There are quite a few. I can send you statistics on that.

Mr. VENTO. It would be helpful to know, because that has a certain appeal. There are probably reasons that regulators and banks and banking groups would like to resist that. It may be more of a necessity in SEC actions. I don't know.

Mr. FINK. You are going to, again, since most of the banks—I say most, I believe so—sell through SEC-registered brokers, they are going to have that same threat of the litigation.

Mr. VENTO. It is something to start out in terms of subsidiaries. I think the concern isn't so much—the concern that is reflected here is when you have the bank sales, you have to sort through which regulator is going to do this, I agree. The banks, though, and the regulators, too, still have a legitimate interest in the safety and soundness insofar as we would like to think those firewalls really work. But I think they are paper, unfortunately, too often. And so I get very concerned.

So I think from a safety and soundness viewpoint, regulators are going to want to look not at the sales or the advice practices, but at other aspects of what a subsidiary is doing in terms of capital flow and any type of potential risk or utilization of bank resources.

In any case, Mr. Jones, any comments? What I am concerned about is the small banks. A small bank can't set up a separate sub, it can't have that type of duplication. You are going to have this type of a provision in terms of the Advisory Act. Most small banks—in Goodhue County and Red Wing, Minnesota, do you hold a lot of mutual funds yourself, in your own portfolio?

Mr. JONES. Mr. Vento, in my own personal portfolio I do have one small mutual fund, but most of my investments are tied up in our own bank stock.

I would like to take just a moment, if I could, to clarify a couple of issues that Mr. Fink talked about over the last several minutes. He talked about differences between the industry guidelines and

the regulatory guidelines that have been put forward and the SEC, and he talked about specifically series 6 and series 7 licensing.

In our particular bank in Red Wing, Minnesota, we have four people who are selling mutual fund products and other noninsured products. All of them have series 6 licenses. We have made sure of that, so that they are well trained.

When we talk about the NASD programs for training, we have approached the NASD, the American Bankers Association, and asked them if it would be permissible for our people to attend those courses and go through that process. The answer so far has been no. So what we have done as an industry is we have approached Dearborn Financial, which does that training, and they are going to be providing that training directly to the banking industry, and we will have testing for competencies and so forth.

Another issue that I heard, I think, Mr. Fink bring forward was the issue of enforcement powers that the SEC has, and certainly no one can deny that, but if we go back to FIRREA, which you gentlemen were involved with, very heavily, we know now that the Federal regulators, bank regulators have very significant powers as it relates to dealing with banks, both national and State-chartered banks, and the guidelines that have been put forward by the Comptroller's office and the joint regulator council have quite a bit of teeth in them. There are civil money penalties available, there are cease and desist orders, removal powers for bank officers and directors.

So I would contend the national banking industry is severely regulated in this area and that there are teeth in those regulations.

Mr. VENTO. Well, obviously, there is a lot to be done. I don't understand all the rules. One of the reasons we are here is because we are trying to gain some expertise in terms of policy. However, the banks face an additional problem, wouldn't you agree, Mr. Fink, in the sense that they have the FDIC insurance present. Does the insurance aspect of this concern you greatly?

Mr. FINK. Very much so. I think that is——

Mr. VENTO. Let me just back up a minute and say one of the reports here that there is a high incidence of misunderstanding both with regards to investment bankers and commercial bankers in terms of the insured nature of those deposits.

Mr. FINK. Oh, yes, the SEC survey showed 32 percent of people misunderstanding brokers and 46 percent misunderstanding bankers. It was worse in the bank channel, though it was troublesome in both channels. That is why the public information campaign we are running this year is not limited to bank customers. We want the public to know that whomever you buy a mutual fund from, it is not insured. I think the insurance issue is the nub of this problem.

Mr. VENTO. I wonder how many people really understand whether they are talking about deposit insurance or Federal guarantees or whatever because a lot of times when the paper is being sold, especially mutual funds, they try to sell this certain concept of stability, and the fact that it is somehow related to Federal investment. I have noticed some funds, in fact some mutual funds specifically focus, the Franklin Fund if I am not mistaken, on its tax-

ability, its insurability, and its assurance that it will not be lost, that it is rock solid.

Mr. FINK. I think two of the problems——

Mr. VENTO. You can't take those tools away from us——

Mr. FINK. I think it is true all over. Investor education is a serious challenge no matter how things are sold. I think in the bank channel it is particularly severe because of the 60 years of FDIC insurance. One of the problems we have encountered is that money market mutual funds were developed with that name in the mid-1970's and later money market deposit accounts came along. The names are so close, that in itself can be confusing. The SEC poll, I gather, was done on the telephone. I think if you ask people about the insured nature of their investments on the telephone, they are not sure what you are hearing.

Mr. VENTO. No, I agree. I just think that the surveys just indicate that there is a lot of consumer confusion. Perhaps it is greater in terms of banks, they may have a higher problem because of the 60 years of experience. It, clearly, is something where the assurance and guarantee of not losing your money are words that are connoted and used to, in fact, make the sale in terms of that particular mutual fund, and so I think it is something to be concerned about. I expect at the short end of the investment, you are always going to find someone that didn't understand that, that was confused by it.

Mr. Martin, you did a survey, you referred to a survey and mentioned the fact the investment bankers actually had a higher degree of misunderstanding than the bankers, so I guess it works both ways. It does show a lot of confusion, and I am sure many of us would question the survey implications. I think there is a concern, a higher threshold issue here with banks on the question of whether we should have functional or institutional type of regulation. That is the question.

I think the answer is you want to have this streamlined, I don't know how you are going to sort it through in terms of the subsidiaries. In terms of the bank it is pretty evident to me that they have their own problems, three or four bank regulators already and are trying to sort through that.

I don't think adding the SEC inside, just on sales and the advice basis, is a viable solution. Even excessive training, and additional training for banks because of the insurance and the other problems they have will help, but adding the SEC into that environment seems to me to be excessive, especially when they are screening every fund that comes into the bank. If we were getting into underwriting, then I think you would have a different issue, but every instrument that is sold in fact, screened by the SEC already.

It is all registered; it is in all prospectus. Is that correct, Mr. Martin?

Mr. MARTIN. That is correct.

Mr. FINK. Sir, there is no screening as far as quality or risk. The screening is as far as——

Mr. VENTO. I think insofar as there is no screening of quality of risk in terms of mutual funds that are sold by investment bankers, so, that is exactly right, we understand that, but I mean insofar as the prospectus—the prospectus, all those instruments are

screened. Now, of course, we are talking about actually the conduct of the individuals in those institutions, and are we going to have—can we have I think a substantially different type of environment? I mean, I think there is a case here to be made.

When you get into a subsidiary, it is essentially doing the same thing and doesn't have insurance, I can understand SEC involvement. I think it is a tougher question that there already exists confusion with regards to the regulatory environment for financial institutions today. We don't do it for insurance.

I guess if you carried this out, you would subdivide regulate in a way that would make banks uneconomical. I think there is a real concern today in terms of what is happening with the financial investment environment and the intermediaries. The way banks have been developed and set up on this basis by the Congress for a couple of hundred years to, in fact, fill a certain function, are now evolving. It is fairly dynamic, and we have got to pay attention to it. Clearly, there have been some problems that have arisen in the recent past when not enough attention was paid.

But in any case, Mr. Chairman, I commend you for holding the hearings, and for our other colleagues that are so interested in the functioning of financial institutions, we need all the help we can get.

Chairman NEAL. You know, just on this earlier point you made, it is my understanding that the SEC does not require disclosure that funds are not FDIC insured; is that right?

Mr. FINK. Yes, it does, for money market funds, I believe, on the cover of the prospectus.

Chairman NEAL. For money market funds, but what about for other mutual funds?

Mr. FINK. When sold through a bank, the SEC requires such disclosure.

Chairman NEAL. Actually, that wasn't my question. The question was generally they don't require this disclosure.

Mr. FINK. No, because normally when you have bond and equity funds being sold by brokers or directly through the mail, issue—and I have been involved for a number of years—the issue of confusion to my knowledge, has never come up.

Chairman NEAL. That is the point, one of the points that has been raised in the hearing today. It surprises me, too, by the way, but what was revealed today was that there is a high percentage of people who think that mutual funds are federally insured. That may seem ridiculous to you. I don't understand it, either, but then again if that is what people think, then it suggests a problem.

Mr. FINK. I would guess it was probably more true of money market funds, which are a third of industry, because of the closeness to the money market deposit account. That is why the SEC requires on the cover of the money market fund prospectus the disclosure that money market funds they are not FDIC insured.

Mr. JONES. Mr. Chairman, I would only add that in the banking industry, both in terms of the regulatory guidelines and in terms of the bank industry guidelines, all of those are disclosed as not FDIC insured.

Mr. SHIVERS. Mr. Chairman, also, I think some of the confusion comes in the general public's mind that when you drive around or

you look in your local paper, you see ads for brokerage firms—and I am using that term very loosely, I am not talking about the Merrill Lynches of the world, I am talking about the little small, one-horse operations. They will have an ad, they will have an electronic message board out front that says 6.95 percent insured.

It doesn't say what it is, it doesn't say who it is or what it is, and I think people constantly see ads like this—heck, it may be insured by State Farm, I don't know. They see ads in the local paper, a little box in the ad about this big that says the same thing, high percentage yield. A lot of investors, that is what they are looking for, they are looking for yield right now because rates are at historic low points.

I don't think they look at the products as hard as they ought to, but I think a lot of the ads from some of these small brokerage houses are very misleading when they give the impression of being insured. They give the impression of yield and safety, and I think we all know that a Treasury bond fund is very safe, but we also know that the only thing we are guaranteed that at maturity we are going to get all the principal back, but it doesn't guarantee us against fluctuations in the market price of bonds.

Chairman NEAL. I am sorry. I think I have taken too much time. Let me yield to Mr. LaRocco, if I can, and we will come back.

Mr. LAROCCO. Thank you, Mr. Chairman.

Mr. Johnson, I appreciate what you said in your testimony about how a customer goes through the bank to buy mutuals and what they receive as information and so forth. If a customer buys a mutual fund from the bank, are the confirmation and then the subsequent statements generated by the bank?

Mr. JOHNSON. Not in the case of Barnett. Our confirmations come from our securities subsidiary.

Mr. LAROCCO. Which has a separate name, of course?

Mr. JOHNSON. It is Barnett Securities, Inc.

Mr. LAROCCO. OK. Does the statement at that point—and this is really a question for all the witnesses, say that the mutual fund is not FDIC insured?

Mr. JOHNSON. Yes, and it says that the securities company is not a bank.

Mr. LAROCCO. Right on the statement?

Mr. JOHNSON. Yes.

Mr. LAROCCO. Is that common practice in the industry? Anybody?

Mr. JOHNSON. It is becoming common practice.

Mr. LAROCCO. That is good news.

As you may have caught since you have been here, I have asked some questions about retrospective warnings, looking back at the client base, because we have had this huge influx into mutual funds in the last couple of years, for obvious reasons. Mr. Jones, to what extent have customers who bought mutual funds and have not had any subsequent transactions been informed that their holdings are not FDIC insured, sir? Do you know?

Mr. JONES. Mr. LaRocco, I can give you our own experience, which is what I am the most familiar with. In our particular case, both on mutual funds and on annuity sales, we were, by the way, the national bank that petitioned the Comptroller's Office to get

national bank authority to sell the fixed rate annuity product, we have erred on the side of disclosure all along, and so our customers have for sure been fully informed on all nondeposit products all the way along.

I believe it may be terribly burdensome and difficult for the industry to go retrospectively back and find all the people and make disclosures to them unless it were to be done through other mechanisms. For example, a monthly checking account statement has usually a little place in the bottom for messages to customers. We might use that mechanism to blanket all of our customers and therefore, hopefully, hit all of these people.

Mr. LAROCCO. At your bank, the people that sell mutual funds are series 6 registered?

Mr. JONES. Yes.

Mr. LAROCCO. How prevalent is that practice through the ABA? I am going to ask the same question, Mr. Shivers, to you.

Mr. SHIVERS. Most of the people I know, Mr. LaRocco, in banks that are in this business, they are selling direct and not through a third party like I do. Their people are series 6 or 7 license holders. In my case, I use a third-party provider, and it is a series 7.

Mr. LAROCCO. OK. Mr. Jones.

Mr. JONES. That would certainly be the experience of the ABA. I think especially given the industry guidelines that have come forward, more and more banks are, even if they are working through a third party, are getting their people series 6 licensed. That is true of us, and I would forecast to say that probably that is true of 75 percent of the banks in Minnesota that are in this business.

Mr. LAROCCO. Mr. Martin.

Mr. MARTIN. We have 100 employees, all licensed, 6 and 7's. We, from day one in 1988, sold over $1 billion in annuities and mutual funds, and every customer signed four separate disclosures pointing out that there is no FDIC insurance. I guess we were invited today to discuss the overly restrictive provisions of this bill that is pending.

I can assure you that my company, we have regulators in there just about every day. They have a lot of power to implement protections for the consumers. We are doing the very best we can not to step over the line and do anything to jeopardize the relationship with these depositors that are the key to our business.

The overly restrictive conditions in H.R. 3306, just to repeat myself, is the rigidity here in locational segregation, the inability of a branch manager who is licensed to sell a mutual fund or an annuity is absurd. This is excessive.

Mr. LAROCCO. Do you feel, Mr. Martin, that if we had a 400-point drop in the stock market and a collapse of the bond market that all of your customers, and the customers of banks across the country, would fully recognize that their investments are not insured? When their principal has decreased in value and their holdings are not worth what they were when they made the investment, would they understand that they had been informed on this?

Mr. MARTIN. They would be terribly disappointed. I would be as an individual. Some would even allege that we misled them, but if they all signed off on these disclosures that clearly point out that it was not federally insured, that is about as far as we can go.

We have the same as Wells Fargo has, these counter signs. We write to our depositors every month, we explain over and over that these are uninsured products that they have invested in. Once a year we remind them in writing, each individual investor, about what the potential loss of principal could be in terms of an uninsured product.

That does not mean that individuals will not blame us or be disenchanted or unhappy with a 200-basis point reduction in market rates because we know that can very well happen in the next cycle. We are doing the best we can on this disclosure issue. I can't stress that enough to you.

Mr. LAROCCO. I think that is the reason you are here, too, to tell us what is going on in the marketplace and how you are interfacing with your clients and customers because what is happening out in Idaho may not be the same as what is happening in Red Wing, Minnesota.

Mr. MARTIN. Thank you very much.

Mr. LAROCCO. Mr. Johnson.

Mr. JOHNSON. With regard to our licensed salesmen, they are all series 7. With some trepidation, I would like to compliment the bank regulators because after the surveys——

Mr. LAROCCO. Next thing you know, Mr. Johnson, you are going to say thank you to Congress, and then you are going to be on thin ice.

Mr. JOHNSON. Probably not today. After the surveys came out indicating some customer or consumer confusion with regard to insurance, the regulators got together and issued interagency guidelines. These guidelines applied not only to the sales activities, but I think importantly to the referral activities, referrals by bank personnel who are not licensed, and I am convinced that the guidelines are speaking directly to the confusion by the customer, no matter where they get introduced to the mutual fund activity, and I think this process will change the survey results over time.

Mr. LAROCCO. OK.

Mr. Fink, anything before I yield back?

Mr. FINK. I would like to clarify one thing, if I could. I did find this statement in my testimony, "the SEC requires all mutual funds that are sold or offered through banks to disclose on their cover that they are not federally insured or guaranteed by the bank."

Mr. LAROCCO. OK, well, thank you very much.

Chairman NEAL. That is an interesting point.

Mr. LAROCCO. Thank you, Mr. Chairman.

Chairman NEAL. Yes, sir, thank you. It doesn't require that all mutual funds sold to everybody include disclosure?

Mr. FINK. No, there are several requirements. If it is a money market fund the disclosure is required no matter where sold, but not for bond and equity funds sold elsewhere.

Mr. VENTO. Does the SIPC fund insure mutual funds sold by both banks, and by investment bankers?

Mr. FINK. No, because SIPC, Mr. Vento, is a different kind of insurance that I think has never been properly explained. It comes up in confusion a lot. It insures you if you leave securities or cash

at a brokerage firm, have a margin account or money held by a managing agency.

Mr. VENTO. I appreciate the insight because I think——

Mr. FINK. If the broker goes bankrupt or somebody steals your assets, you are insured, but it does not insure you if you buy General Motors stock or mutual fund shares for $50,000 and their market value goes to $20,000, you are not insured. SPIC does not insure against market fluctuation.

Chairman NEAL. But the same kind of SIPC insurance that insures an equity left with the broker, does it insure a mutual fund——

Mr. FINK. If you left your fund shares with the broker? I am sorry, I didn't understand the question.

Mr. VENTO. Mr. Fink would probably acknowledge, too, that in the advertisements that were presented here that in fact some of the representations made with regard to SIPC fund, could lend themselves to a lot of problems that are similar to the problems that we are having with banks. While I understand the fundamental purpose of this is different, I was just wondering how it affected and might be applicable to be misinterpreted. For instance, on the front of the mutual fund or money market account for an investment banker, it states one thing, but it also states something else, so consumers reading this could obviously be confused. This could be used appropriately in both instances, but the end result is that you have ended up confusing the issue beyond any rational understanding or any hope for understanding by consumers.

Mr. FINK. I think it is confusing, and I said that one ad I found very confusing, but I must say I have never found a mutual fund ad proclaiming SIPC because it just doesn't fit. It insures brokerage accounts, not mutual funds.

Mr. VENTO. It doesn't seem to fit in some of the ways we have seen it represented here. I am sure you would agree. If we can pound a stake through one of the hearts here, I hope that we don't have another one out there ready to perpetuate the same problem, that is all, and that would be both as with regards to commercial and investment bankers.

Thank you. Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir, very much. I just have one other question if I may. Mr. Jones, how do the industry guidelines differ from what the regulators propose in this area?

Mr. JONES. Mr. Chairman, the industry guidelines that were the product of five trade associations really have gone farther than the regulators' joint statement. For example, the industry guidelines recommend model customer acknowledgment and agreement to arbitrate. In addition, the industry guidelines flesh-out the complying with the regulators pronouncements.

Chairman NEAL. So there is nothing in the regulators' guidelines that you all find particularly onerous or unreasonable?

Mr. JOHNSON. Mr. Chairman, I think it would be important to maintain the dynamic nature of guidelines prior to any legislation because this industry, with regard to banks is evolving, so I think you heard it from the regulators as well, we would like to work together and fine tune as time goes on rather than codifying what we think is right today.

Mr. SHIVERS. Mr. Chairman, the various banking associations did work very closely with the regulators, so they had a lot of input into them. We think they are a very fine set of guidelines that probably covers the theater very well.

Chairman NEAL. Thank you. Just one final question.

Mr. Johnson, the procedure that you described in your testimony, as I recall, it was for sales of mutual funds. This is a complicated procedure. Is that for your bank or is that an industrywide procedure?

Mr. JOHNSON. That is specifically for our bank, but we are finding that becoming more common around the large banks that are selling mutual funds.

Chairman NEAL. Thank all of you very much for coming today. Thank you.

We have one more panel. The last panel is comprised of Mr. Chris Lewis, director of banking and housing policy, the Consumer Federation of America; Mr. Philip Feigin, securities commissioner of Colorado, and president-elect of the North American Securities Administrators Association of Arlington, Virginia; Ms. Tess Canja, member, board of directors, American Association of Retired Persons; and Ms. Diane Colasanto, president, Princeton Survey Research.

I would like to welcome you, thank you all for joining us. If there is no objection, we would like to hear from you in the order in which I mentioned your names. If there is no objection, we will just go ahead and start with you, Mr. Lewis. I would ask that you— we are running a little behind schedule here, if you all could limit your comments to about 5 minutes apiece, that would give us time for a little question and answer period.

Mr. LEWIS. Thank you, Mr. Chairman. Obviously, the Consumer Federation appreciates the opportunity.

Chairman NEAL. We will put your entire statements in the record and ask that you summarize for us. Thank you.

Now, Mr. Lewis.

STATEMENT OF CHRIS LEWIS, DIRECTOR, BANKING AND HOUSING POLICY, THE CONSUMER FEDERATION OF AMERICA

Mr. LEWIS. I will attempt to do that, and obviously we appreciate the attention that you are bringing to the subject matter today. The increased securities activities of the banking industry, we believe, creates a number of public policy concerns, chief among them, as has been discussed this morning and this afternoon, is the increasing consumer confusion about the degree of risk of investment products sold on the premises of insured institutions, and the fact that, as was pointed out quite eloquently by Mr. Fink on the previous panel, that Federal banking law is inadequate to the task of providing basic protections for commercial bank customers that are entering the world of investment banking.

We believe that the current head-long rush by the banking industry into the retail mutual fund and annuity businesses must be placed in proper perspective. First, we find no clamor by consumers for further expansion by banks into the mutual fund business. We do monitor consumer concerns, and we are not in receipt of a great

demand on the part of consumers for more mutual fund outlets, whether operated by banks or other entities.

Second, and as this subcommittee is well aware, the banking industry is enjoying record-setting profits, and thus there seems to be no emergency need to open new lines of business to protect the industry.

Third, as has been discussed at great length this morning, there is widespread confusion among the public about the nature of risk associated with investment products, including mutual funds sold by banks, as well as confusion more generally across the financial service marketplace about the nature of risk of investment products.

Finally, the Congress, through various bills that have been introduced, is attempting to establish specific statutory guidelines to end the confusion among the industry, the regulators, and most importantly, among the public. We believe, Mr. Chairman, that the evidence indicates that banks' current sales practices in the area of mutual funds and related uninsured products are all too often designed to lead the unsuspecting customer into believing good old Uncle Sam and the taxpayers are guaranteeing the investments.

Yes, there are good players in the marketplace, but we believe there are many bad actors out there. As this subcommittee is well aware, these investments, like all investments in the stock market, carry risk and none of that risk is protected in any manner by the Federal Government.

In short, we believe that the protective shield of the Federal Deposit Insurance Corporation, long a symbol of security for millions of American consumers, is being tarnished by bankers who are hellbent on becoming big time players in Wall Street's mutual fund market. The industry, as well as the Congress and this subcommittee in particular and the American public, should want that shield and the integrity of that shield protected. The full faith and credit of the U.S. taxpayers symbolized by that FDIC logo should not be utilized by the banks as a means directly, indirectly of duping consumers, bank customers into believing that investments in the stock market are risk-free.

So we know we have a clear problem, a genuine problem as Comptroller Ludwig put it earlier this morning. What then have the regulators done to attempt to clean up the marketplace? Unfortunately, in our belief not nearly enough.

The response by the banking regulatory agencies to the rising tide of securities activity has been one of banks first and customers, consumers last. Three weeks ago the banking agencies, as has been pointed out earlier, came up with an interagency statement on retail sales of nondeposit investment products. What has emerged in this policy statement is a set of lowest common denominators, with "should" not "shall" as the dominant word.

In a number of critical areas, as my written statement summarizes, we believe the interagency statement does not correct egregious practices, but rather institutionalizes them. We believe, as my written statement points out, that there is a dire need for the Congress to act in this area to establish basic statutory guidelines for bank sale of uninsured products.

I do discuss in my written statement some of the basic outlines of legislation that we would like to see the Congress act on. We compliment the chairman of the full committee and Congressman Schumer for introducing H.R. 3306 and do recommend some revisions to that proposed legislation.

In short, that those provisions should include a complete ban on the use of similar names or logos by an insured bank and its uninsured securities affiliate. We believe that all persons who sell securities investments on bank premises must be SEC registered and meet a high standard of suitability training and conduct as has been discussed by previous panelists.

The use of testers by regulatory agencies should be a mandatory component, we believe, of every bank compliance program. We believe the committee should consider including a provision in the legislation to bar or ban compensation by commission for the sale of uninsured investments to bank customers to try to remove some of the incentives for marketing employees and contract marketers to simply sell, sell, sell without adequate recognition of a bank customer's suitability needs.

We believe additionally that the legislation should include a cooling off period for consumers so that consumers could rescind an investment decision without penalty. In conclusion, Mr. Chairman, while this subcommittee, the Congress as a whole, and regulatory entities and the industry continue to debate just how far banks should reach into the securities business, we believe that the Congress has a clear obligation to provide consumer protections up front, safeguards that will prevent FDIC logos and insurance from being transformed from symbols of personal and financial safety into deceptive marketing tools for bank-sold securities.

I might say, Mr. Chairman, I do refer in my written statement to an article in *Consumers Report* and a letter that I received from a major bank holding company. I would like if possible to introduce those into the record.

Chairman NEAL. Without objection, it is so ordered.

[The prepared statement of Mr. Lewis and the material referred to can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much. Now we would like to hear from Mr. Feigin.

STATEMENT OF PHILIP FEIGIN, SECURITIES COMMISSIONER OF COLORADO, AND PRESIDENT-ELECT, THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION OF ARLINGTON, VA

Mr. FEIGIN. Mr. Chairman, Mr. Vento, thank you very much.

Good afternoon. My name is Phil Feigin from the Colorado Securities Commission and the president-elect of the North American Securities Administrators Association [NASAA]. In the United States, NASAA is the national organization of the 50 State securities agencies.

I appreciate the opportunity to appear before you to comment on the very serious consumer protection issues that arise from the sale of uninsured investment products on bank premises.

Today, State securities regulators across the country are reporting mounting evidence of consumer confusion about insurance cov-

erage, and the risks and fees associated with the sale of mutual funds at banks. An informal look by several States at what is actually going on in bank lobbies makes it very clear why consumers are so confused. The marketplace is sending them a bewildering array of mixed, garbled, and misleading messages.

We have uncovered a lot of problems. First, there is a blurring of distinctions between traditional bank activities and the sale of mutual funds. You don't know if you are talking to a banker or a broker.

Second, disclosures about FDIC coverage are inadequate and in many cases misleading. Even more disturbing is the misinformation being disseminated at banks about SIPC insurance coverage. Bank customers are being led to believe that if you like $100,000 FDIC coverage for a CD, you are going to love $500,000 SIPC insurance for mutual funds.

Third, sales practice abuses are common. Few investors are judged as to their suitability for the investment products and many are misled about the risks associated with the stock market. I would like to focus now on what can and should be done to address these very serious concerns. Many of these issues are recognized in the legislative reform proposals now pending before Congress.

For example, H.R. 3306 would impose enhanced risk disclosure requirements, including absence of FDIC coverage, and impose advertising restrictions and physical segregation requirements. It would create a regulatory system for bank securities personnel, restrict the use of common names, and place restrictions on the use of bank customer financial information.

Let me address the last point first. Not only as a securities regulator but just as a citizen, I was shocked to learn that there are currently no restrictions on what my bank can do with my personal financial information. It is for sale.

In Colorado, and apparently in the rest of the country, it is now common practice to feed maturing CD and other customer financial information to the brokerage firms with which they are affiliated. Customers think they are talking to the bank and have no idea they are being converted from insured depositors to at-risk investors.

We applaud the proposal in H.R. 3306 to restrict the use of this information and suggest that the use of personal financial information in general may be worthy of further congressional review. NASAA also strongly supports the common name restrictions included in the bill and, if anything, believes that the reforms should go further.

Will we really clear things up in the mind of consumers if we won't let banks use their names in the title of their mutual funds, but have allowed them to use their names in the title of the brokerage firms that sell those funds?

The other features of H.R. 3306 are laudable, but NASAA does not believe they can be implemented effectively under the regulatory structures set forth in the bill. What is most troubling about H.R. 3306 is its apparent rejection of the concept of functional regulation. Banking regulation in this country is designed to insure the safety and soundness of financial institutions. State and Fed-

eral securities regulation is about investor protection, sales and sales people.

Between the SEC, the 50 States, and the self-regulatory organizations, we have crafted a highly integrated and complex system of licensing, testing, sales practice regulation and discipline. There are extensive regulatory, criminal, and private civil remedies available in the case of violations.

At a time when the administration is calling for consolidation and cost-cutting measures, it seems contradictory that the Congress would consider instructing Federal banking regulators basically to xerox more than 80 years of State and Federal securities laws and regulations. The train is out of the station. We can't afford to wait while the banking regulators reinvent the wheel.

When and if they do gear up to police securities sales people, what is it that they are doing now to ensure bank safety and soundness that they won't be doing then? Today I know if an applicant for a Colorado broker's license has been in trouble in North Carolina or revoked in Iowa.

Now, let's look at the world under H.R. 3306. If that same broker worked instead for a national bank, even if the OCC were to make the bank fire him, that banished salesman could go to work at a bank in Iowa and no one is the wiser.

Could we also really be contemplating the duplication of the computerized licensing system in place for securities brokers? It is important to note we are not saying that securities and mutual funds should not be sold at banks, and we are not attempting to lay blame anywhere or with anyone.

The marketplace has changed, and we are all seeking to react to those changes. There will only be blame if now that we have discovered the problems we don't act aggressively and cooperatively to fix them.

We urge you to support the concept of functional regulation and let the securities regulators do our jobs to protect investors. There is still plenty to be done on the bank side, and we encourage you to continue to explore the possibilities, but in the context of functional regulation.

Thank you.

[The prepared statement of Mr. Feigin can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much. Ms. Canja.

STATEMENT OF TESS CANJA, MEMBER, BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS

Ms. CANJA. Thank you, Mr. Chairman.

My name is Tess Canja. I am a member of the board of directors of the American Association of Retired Persons. I am from Port Charlotte, Florida.

I am pleased to be here today to present AARP's views on bank sales of uninsured products.

Gone are the days when every product encountered in a bank lobby was federally insured. All sorts of uninsured products are now being sold at banks, including annuities, mutual funds, life insurance, and brokerage services. While the range of products of-

fered by banks has been increasing, so has something else; consumer confusion.

Consumers today are being subjected to aggressive marketing campaigns by banks that sometimes blur the distinction between what is insured and what is not, and as a result current banking practices are contributing to marketplace confusion.

Banks selling uninsured products tend to fall into three categories. First, there are a large number of banks engaging in questionable practices. These include using identical logos for insured and uninsured products, using names similar to the banks to identify bank-offered mutual funds, not disclosing deposit insurance status on some uninsured products, and commingling lobby advertising and promotional literature for insured and uninsured products.

Other banks are providing perfunctory legalese disclosures. These are usually in very small type, buried as footnotes that require some hunting to find or they appear in lobby advertisements that a customer has to stoop to read.

Then there are another handful of banks that go beyond minimum requirements and provide highly visible disclosures in lobby displays, brochures, forms, and advertising, all designed to make very clear distinctions between insured and uninsured products.

AARP believes it is time for the Federal Government to step in to bring some sense to today's marketplace. The following actions we believe are needed.

First, strong congressional mandates to protect consumers who might unwittingly place their life's savings in jeopardy by investing in uninsured products at their bank. Passage of this legislation is needed before a market correction causes unexpected losses for these investors.

Second, until the above statutory protections are in place, AARP urges Federal banking regulators to proceed with extreme caution before approving any new banking activities which could add to consumer confusion; and third, while Federal banking regulators are to be commended for identifying and taking some steps to address consumer protection, much stronger enforcement is needed.

We recommend the following enforcement strategies for identifying and correcting marketplace abuses.

First, send testers into bank lobbies. To more accurately gauge conditions in the marketplace, anonymous testers need to be sent into bank lobbies to gather information on bank sales practices, product promotions, oral representations, written disclosures, and other related activities.

AARP also recommends that a system be developed for capturing consumer complaints. Most consumers do not know where to complain if they have problems with uninsured products sold by banks. A uniform consumer complaint form needs to be developed, made publicly available in bank lobbies, and distributed to all purchasers of uninsured bank products.

Third and finally, AARP recommends that a series of field hearings be held by Federal banking regulators to solicit public opinion regarding bank sales of uninsured products. Such forums would generate significant media attention and would help educate the public on the differences between insured and uninsured products.

Thank you for this opportunity to comment. AARP looks forward to working with the subcommittee toward achieving the goals identified in this testimony.

[The prepared statement of Ms. Tess Canja can be found in the appendix.]

Chairman NEAL. Thank you, ma'am, very much for your help.

Now, Ms. Colasanto.

STATEMENT OF DIANE COLASANTO, PRESIDENT, PRINCETON SURVEY RESEARCH

Ms. COLASANTO. Thank you, Mr. Chairman.

I am Diane Colasanto, president of Princeton Survey Research from Princeton, New Jersey.

In October, my company interviewed a random sampling of 1,000 bank customers who say they are the financial decisionmakers for their households. What they told us makes clear that many still cling to notions about the safety of bank accounts when they think about the wide array of new products offered by banks. They don't realize that the mutual funds, stocks, and annuities sold by their banks are not insured by the FDIC Program.

Only 18 percent say the mutual funds sold by their banks are not insured. Twice as many, 39 percent, are wrong in thinking bank mutual funds are insured, and another 43 percent say they just don't know.

What is really remarkable is that even the people who have actually purchased mutual funds at their banks are not well-informed about the risks involved in these investments. We would expect at least this group of purchasers to be knowledgeable about whether their investments are insured or not. After all, they have spoken to someone at their bank about the investment, they remember receiving disclosure documents, and most say they read the disclosure information, but these investors are not more knowledgeable about risk.

In fact, investors are even more likely than other bank customers to think these bank products are FDIC insured. Half of the mutual fund investors think their mutual fund is insured, and another third aren't sure whether it is insured or not. These investors are confused about other aspects of their investment, not just risk.

Between a quarter and a third don't know whether or not they are subject to a variety of common fees. For example, only 36 percent of bank mutual fund investors say they are charged a front end sales load, even though most bank mutual funds include this fee. The misperceptions about FDIC coverage that our survey reveals are widespread throughout the population of bank customers.

Even though our analysis shows that there are differences in knowledgeability about FDIC coverage by gender, education, and income, we find no subgroup of bank customers where most people are clearly aware of the limitations of FDIC coverage.

There is one demographic difference worth mentioning, however. From our data it seems banks are marketing uninsured investment products more aggressively to older people. Half of the bank customers over the age of 65, but just a third of younger customers say they were contacted by their bank about purchasing a mutual fund.

So consumers are confused about the investment products their banks offer. They are confused, but they are also trusting.

On a final note, we found that consumers trust their banks to give them good information. Eighty-eight percent feel they have never been misled or misinformed by their bank. Few, only 5 percent, would contact any government agency if they had a problem with their bank.

Most, 82 percent, would deal directly with the bank and few could name a source of help other than a bank employee when pressed to think of how they would personally handle a problem concerning their own bank investments or accounts.

Thank you.

Chairman NEAL. Thank you very much.

Mr. Lewis, if a bank were to try to convince a customer that a noninsured mutual fund is in fact insured, wouldn't that be an example of a criminal act of fraud?

Mr. LEWIS. One of the problems that we have is that the fraudulent—we do not have a clear standard of fraudulent practice in this activity the banks engage in. We do have that under the securities laws for registered broker dealers, but there is not yet an equivalent standard, as I understand. Mr. Feigin might have better information on that, and I would be glad to go back and check, but that is my understanding.

Mr. FEIGIN. A short answer would be yes.

Mr. LEWIS. Excuse me. I stand corrected.

Mr. FEIGIN. It would be clearly criminal in that any sale of a security taking place in the United States is subject to the Federal securities laws and a willful violation of the antifraud provisions like that where a salesman simply said this is insured when it wasn't would be a willful misstatement of a material fact, and I believe would amount to a criminal violation of the law.

Chairman NEAL. Whether that salesman is a bank employee or an employee of a brokerage house or whatever?

Mr. FEIGIN. It would make no difference.

Mr. LEWIS. I think one of the concerns, Mr. Chairman, that we have is that there has not been a track record nor are we confident there is a current compliance procedure in place to be able on the part of the banking regulators to detect such willful criminal acts. That is why we believe the Congress needs to step in or certainly the regulators need to beef up their compliance activities and enforcement efforts in this area.

Chairman NEAL. But if a person felt that they had been subject to some fraudulent representations, couldn't they report that to the Justice Department and wouldn't the Justice Department proceed or what would be—how would this be dealt with?

Mr. LEWIS. Again, one of the problems here is we are not going to know until it is too late and the consumer is not going to know perhaps until it is too late if they have been given inadequate information, inappropriate information, or have been misinformed about the nature of a recommended investment, and if that investment goes south, they won't know until that point that they were abusively treated in the marketplace.

Chairman NEAL. I thought you said in your testimony that you knew of examples of this sort of activity.

Mr. LEWIS. Well, we do—there is a fair bit of information contained in other statements regarding what we believe to be deceptive or misleading promotional materials. I have walked through bank lobbies in this town on K Street and I can assure you that in the majority of lobbies on K Street as of 6 weeks ago one could find numerous examples of promotional materials that did not meet either the industry's guidelines, voluntary guidelines, or the standards that were set forth in the interagency banking regulatory statement of 3 weeks ago. I would be glad to provide for the record examples of those promotional materials.

Chairman NEAL. I do think that is a little bit different than charging fraud, but anyway—isn't that what you were doing? Weren't you charging fraud on a number of banks in your statement? That is the way it sounded to me, as a matter of fact.

Mr. LEWIS. We are concerned about deceptive marketing practices and promotional materials that attempt to blur the distinction between an insured product and an uninsured product. We are particularly concerned about this occurring in lobbies of insured institutions where consumers, as has been discussed in prior panels—where the banking industry has enjoyed an enormous amount of goodwill as a result of the provision of deposit insurance that this subcommittee has repeatedly assured the public is available.

Chairman NEAL. That is why we are holding the hearing today. We think there is a possible problem. But, again, I still think that that is a little bit different than charging fraud. If you have evidence of fraud, I think you ought to turn it over to the appropriate authorities.

Mr. LEWIS. I would be glad to put in the record various examples of promotional materials that in our view would lead to misinform consumers about the nature of risk. That is what our principal concern is as well as another prior discussion that you raised about the adequacy of disclosure and the consumer's signature on a disclosure statement that an investment instrument was not insured.

We would like the record to show that disclosure is certainly needed and that it is very proper and we are very glad that the industry is requiring such written disclosures, but there is a much larger gray area in the oral representation made to consumers which may put into the background the information contained in a written disclosure and slide over the importance in an oral representation of that information.

Chairman NEAL. How would we deal with that?

Mr. LEWIS. This is why we recommend that the regulatory agencies as an ongoing part of their Compliance Program engage in a testing program, that you need to walk in and experience, have the compliance officials experience the oral representations of marketing officials, and that really, to our knowledge, is the only way to detect problems that may arise in the oral sales pitches.

Chairman NEAL. Mr. Feigin, you have experience in this area. What do you think about that?

Mr. FEIGIN. Yes, we do. First of all, on the criminal side, the cases are never quite as clear cut as you would propose. Would that they were. That it is so easy to prove fraud.

Second, the laws are violated all the time. It is a big country and a huge industry, but you can't get to each of them. That is why we

are so dependent on the regulatory structure to at least try and deal with things administratively and also on the ability of citizens to bring private rights of action or seek arbitration, which is something that might be missing on, were the banking proposal to be adopted.

As far as we have seen in the last couple of months, the State securities regulators have spent a lot of time in the lobbies of banks, either posing as investors or just examining things in the exercise of regulatory authority, and we were not only disappointed in what was going on, we were at least in one case shocked that one thing that we had not even heard of, the confusion about SIPC was going on and being relied on and used as a motivating tool to get people to invest.

I want to make it clear that we are again not talking about unlicensed bank people doing this. They were also people with licenses. It didn't seem to matter. We are focusing on banks. We have found some very disturbing material, and I think in the next few months you are going to see some significant enforcement actions brought within our regulatory authority to stop that kind of advertising, and misstatements.

Chairman NEAL. Do you agree with the proposals of the regulators? Were you here this morning to hear?

Mr. FEIGIN. I certainly was.

Chairman NEAL. Do you agree with what they are suggesting?

If you don't agree, what would you do differently?

Mr. FEIGIN. Well, I think, as I said in both the oral statement and the written submission, we think the proposals are laudable and that they are going down the correct path. It is just like occurred in 1911 with the first State securities law, and 1933 and 1934 when Federal securities law arose and started to be implemented.

My concern is that you will have this bifurcated system where to engage in almost identical activity may be more desirable during one particular period to be subject to Federal banking regulation as a seller of mutual funds because that regulator is either undermanned or giving sales people an easier break or their rules are more lenient and another time decide to be a securities licensee because their rules are easier. You would have this almost regulatory arbitrage trying to decide who is an easier regulator to abide by.

Also, I am concerned about the fact that there are not State regulators who are going to be involved in this, and we have found that as things have evolved, the SEC takes care of the big picture of the marketplace and the State securities regulators have tended to be the local policemen on the beat. There is no similar—there is no corollary in Federal banking regulation, so although in principle the things that they are writing down are laudable and good, and I would agree with them because they already exist in securities laws, the enforcement mechanism, I believe, will fall short.

Chairman NEAL. Are there others of you who want to comment on this? Miss Canja.

Ms. CANJA. We have some concerns also about a dual system. One of the problems now is that older persons or anyone who might have concern about the purchase of some of these products

really doesn't know where to go for relief or complaint, and anything that can simplify that I think is very important from a consumer's standpoint. One of our recommendations is to have a consumer complaint operation where people really can have—can know where to go to complain, but if a person has several kinds of mutual funds purchased in different places, it can be very confusing if there are different regulators.

Chairman NEAL. Mr. Lewis.

Mr. LEWIS. Mr. Chairman, on the question of the interagency statement, I do tick off in my written statement a number of areas where we believe that it could stand improvement. Again, we do applaud the regulators for taking this step but believe they need to go further.

We are concerned about a couple of elements there that tend to, in our belief, endorse or institutionalize practices that we believe lead to confusion in the marketplace. They are in my written statement. Briefly, they have to do with permitting tellers, the handlers of insured products to receive referral fees for making a referral. We believe that very much leads to more confusion, and doesn't clean up confusion in the marketplace.

Similarly, the joint agency statement would permit promotional brochures to include advertising for both insured and uninsured in the same brochure, and again we believe that leads to more confusion. It doesn't help clean up the marketplace.

Chairman NEAL. Ms. Canja and many others recommended that banks and mutual funds sold by a bank not be allowed to carry the same name. I don't understand that, to tell you the truth. I just think the whole idea is to provide more services for customers, as I understand why banks want to do this. They want to provide more services for customers and they want to have different sources of revenue. Now, if they had a full disclosure of the fact that a mutual fund were not federally insured, what would be the harm of having it carry the same name?

Ms. CANJA. I heard someone this morning call it consumer psychology in dealing with a bank. There is a tremendous trust to a bank, and something carrying the bank's name there also would be a carryover of that trust. I would like to share a personal experience with you.

Before I knew I was going to testify, we recently sold a house and we had some cash, and I deposited it in our bank. The teller invited me to have a bank counselor, investment counselor talk to me, and so I made an appointment. The counselor called and made an appointment, and I have to say that she did disclose orally the things that she should have disclosed, but then when I knew I was going to testify, I took the materials home and I decided to look at them more carefully, and I think there is a question.

I heard a lot of guidelines about disclosure, and I think the materials I have probably fulfill those guidelines but in peculiar ways. In this particular little brochure, the mutual funds that the bank carries that are not its own funds have very—have the disclosure language about uninsured deposits in the bulk of the copy in the same type, but when they are talking about their own funds, when they are talking about annuities, they have it in 6 point type at the bottom, and that makes no sense to me.

Then I received some other materials about specific products that are very descriptive and more in detail, and there is nothing here about uninsured, there is nothing also which concerned me about fees, and so there is disclosure and then there is disclosure, you know, and so maybe there just have to be strong regulations saying you will disclose, you will do it in the body of the type, you will not use 6 point or 8 point type or whatever it is, it will be readable.

We are particularly concerned about—and again going back to this consumer trust, about older persons who are getting such a low rate now on their CDs, they are looking for a better investment, and they really will be very vulnerable, and they need proper disclosure.

Chairman NEAL. Yes, ma'am. But that is what this proposed legislation and the proposed regulators proposals are all about. That is what I am trying to get at. Is that adequate?

Ms. CANJA. We would like to see it in legislation.

Chairman NEAL. So let's take the content. Do you think, do you agree with what the regulators are proposing or would you——

Ms. CANJA. I think it is a step in the right direction. One of our recommendations, for example, is to send testers into bank lobbies, and the FDIC said that they have a plan to do this, and we thought that was wonderful, but we would like to see it with a strong backing of congressional mandate.

Chairman NEAL. Well, let me ask you all about this. There was a point made by the bankers and the regulators, I think, that this industry has evolved and the products offered by the banking industry are evolving and the products offered by the securities industry, and they are evolving and changing almost daily. It is a dynamic. We live in a very dynamic kind of economy, and we encourage those kind of changes, creativity, and so on in the marketplace.

The worry about legislation is that it would freeze into place a set of particular proposals and that the marketplace would change and the needs would change and so on, so both the regulators and the bankers argue for regulations which they spelled out in detail, and they favor the regulations because they could be changed without going through the whole legislative process again.

Is that a sensible proposition or not?

Mr. FEIGIN. I guess I would say Glass-Steagall is a law, too. It seemed to freeze things in place, but we had a bit of a thaw over the last 10 years.

An organic bill provides the sufficient latitude in a regulatory environment and provides rulemaking authority to somebody who can enforce it; that is not a particular concern of mine. I have not seen any of the activity that would not be accommodated by the securities law but for an historical exclusion whose purpose may have long since expired. That is the exclusion of banks from the definition of broker dealer.

Mr. LEWIS. I might just add to that, Mr. Chairman, the legislation that the committee chairman has introduced intends to establish basic common standards for the sale of uninsured products, and leaves to the discretion of the regulatory bodies the terms of exactly how those standards are put into play in the marketplace. And certainly, as we saw with the witnesses from the regulators

this morning, they are going to, on an ongoing basis, continue to identify problems and address it under their existing authority.

But we do feel there needs to be a common set of standards that consumers can expect to enjoy wherever they enter the investment marketplace.

Chairman NEAL. Ms. Canja, did you want to comment?

Ms. CANJA. One other comment, possibly, and that is that the standards—you know, some banks are abiding by them right now. They are setting standards themselves. And I guess what we would like to see is all the banks following suit.

Chairman NEAL. That is what the regulators say they are interested in. Do you think that would be adequate? That is all right. I think I have got your response.

Let me ask you, if I may, Ms. Colasanto, a question came up a little earlier about—well, I think it was the American Association of Retired Persons' survey showed that a high percentage of people didn't know that mutual funds offered by insured institutions were not insured, and your research indicates the same sort of misunderstanding, I think.

Ms. COLASANTO. That is correct. This is a survey, by the way, that we did conduct on behalf of AARP and NASAA.

Chairman NEAL. So it is the same survey?

Ms. COLASANTO. I believe it is the same survey.

Chairman NEAL. Someone else said that they understood not only is what you just discussed true, but also a large percentage of people who invest in mutual funds outside the banking system think that those mutual funds are insured. Could you get into that question at all?

Ms. COLASANTO. Our survey looked specifically at perceptions about mutual funds sold by banks, and we were very careful in how we structured the questionnaire that respondents would know exactly which institutions, in other words, their own institution, we were talking about.

One thing we did in our analysis that may be the thing that was referred to is, we looked at people who also had relationships with other kinds of securities dealers, in other words, had invested outside of the banking environment to see maybe they were a little bit better informed than people who were dealing exclusively with banks, and what we found was there was a difference in perception.

The people who we labeled more sophisticated investors had better information about the fact that mutual funds sold at banks were not FDIC insured, but even there, it was still a minority of even that sophisticated group knew they are not insured. It was different than all the other bank customers we looked at, but still not a majority—you know, at least a majority saying, No, those products aren't insured.

But the products they were talking about were not the products sold elsewhere. They were the products sold at their bank.

Chairman NEAL. This is not an entirely fair question and I don't expect you to be an expert on this, but I was just wondering if you formed an opinion, just listening to the testimony, whether or not you think that what the regulators are suggesting would be enough to inform people that their mutual fund investments aren't insured.

Ms. COLASANTO. You are right, that is really not anything I can answer. What I can tell you is what the state of consumer perceptions are right now, and that there is a tremendous amount of confusion out there.

Chairman NEAL. I am trying to get at what it would take to correct that. I have been told, I don't know if it came up today or not, but often people will sign statements saying that they know that a product is not insured and then later if you ask them, they will say, "No, I thought it was insured."

Ms. COLASANTO. In fact, we found that in our survey, people said, I got this disclosure and I read it, and they are the same people who are not paying attention to that particular form of disclosure. That was a very——

Chairman NEAL. It is hard to know how to correct that, isn't it? What would you do in a case like that?

Mr. FEIGIN. If I may, sir, we have found in a lot of our examinations that the customer folders of investors, of people who invested through banks, have disclosure statements in them. I don't know if you ever sat through that. I refinanced my house a couple of months ago. I signed a dizzying array of things, some from the EPA, some from the bank—and I am a lawyer. I didn't read them.

I think when people are convinced that they want to buy something because they are going to be richer, the idea of signing technical disclosure forms is not particularly exciting nor does it draw their attention.

I use the example in some speeches I give that I ask the audience, have you ever rented a car? They say, oh, yes. I say, do you ever read the rental agreement, I mean really read it? No. Why? Because you want to get in your car and drive away. That was the document written by the car-leasing attorneys.

So the point is we found that documents are used more as a sword to protect the institution than they are to inform the investor.

Chairman NEAL. Might a possible solution be to require a statement on a full-size sheet of paper attesting to the fact that a person understands that mutual funds are not an insured product and that—maybe repeat and say, notwithstanding whatever else I may have been told. Might that adequately inform?

Mr. FEIGIN. I think what has happened is that securities regulators and perhaps others have tended to react based on past experience. The answer has always been another disclosure form, or perhaps move them another 10 feet that way or something like that. I am not sure we know yet what disclosure or what mechanisms will work to overcome the FDIC insurance and now perhaps the SIPC insurance issue.

What we propose to do is to do pilot studies and really find out what works. It may be as simple as the international sign with the line through it. It may be far more complicated. It may be imposing a requirement as part of the suitability requirements on securities salespeople that they have made an unsuitable trade if the customer leaves thinking the investment is FDIC insured.

I think we have to use our imaginations and come up with what works instead of just applying full solutions that may not.

Chairman NEAL. I wish you would share whatever you learn with us, because——

Mr. FEIGIN. We certainly will.

Chairman NEAL. It seems to me like a fairly simple issue. If we just solve this one problem, if people could clearly understand what it is that they are doing, then it ought to be—the person ought to be able to make an informed choice without reams of regulations. It is not a complicated issue, is it?

Mr. FEIGIN. Certainly, banks were not popular entities in 1929 and 1930. I think the goodwill that has been established over the years is based in large part on the fact that you save at the bank and you go over and invest and gamble and speculate with the broker. And that has really built up a real social institution in the minds of Americans. And we are finding that a very difficult thing to overcome.

And the flocks of people who are buying investments at banks are being targeted by banks and the public relations firms they hire. And I think it may be a stickier thing to try and overcome than we have been able to—than we have identified yet. We have to find new ways, because they are still confused.

Chairman NEAL. Just one question, then I will quit. Did you notice anything in your research, Ms. Colasanto, that would suggest why some people understood and some didn't?

Ms. COLASANTO. No, there weren't any clear indications of why some people got the message clearly and some didn't. As I mentioned in my statement, there were some relationships with education; better educated people tended to get the message a little bit more often than others, but even among people who were college graduates, most had it wrong. So we really didn't have any clear sense of who was getting the message and why.

Chairman NEAL. Back to this point you were making, Mr. Feigin, it would seem to me almost—there was something pejorative suggested when you suggested a bank would try to convert a person from savings to a mutual fund. Is that your feeling about it?

Mr. FEIGIN. I think what is important—and let me highlight what that brief statement was meant to address. We have seen in a couple of our actual enforcement cases that—and I harken back to a point I mentioned that I haven't heard discussed much, and that is the fact that banks are identifying to their brokerage subsidiaries the names of customers whose certificates of deposit are maturing. That customer is being called in the evening by so-and-so who says, I understand your certificate of deposit is maturing; I thought you might be interested in some instruments that offer a higher interest rate. Why don't you come see me at the bank tomorrow.

That is all that is needed. That person walks in, sits down at a desk that is in some cases indistinguishable from others, and the sale is made long before they ever hit the chair, because they are so convinced that the bank has done it.

So the bank is not doing anything to deter—as a matter of fact, I think in that scenario they are encouraging that customer to believe that it is the bank selling them a product, and with that comes the unconscious reaction that, of course, it must be insured. If that person knows my confidential personal financial informa-

tion, they must be affiliated with the bank, because how else would they know?

Chairman NEAL. You know, that issue, we are going to look into it. It would suggest that banks can sell all this information. I am surprised to learn that myself, if that is in fact the case. We are going to look into that. It doesn't seem quite right to me, either.

As far as using it internally, that is a little bit of a different situation. Personally, it is hard for me to see anything wrong with that.

Plus, by the way, if you were to go back and look—if the proposition is that you want to improve a person's financial status, how would you be better off? Would you have been better off 5 years ago, 10 years ago, 20, 30, 40, any period you pick in history, almost? Would you have been better off putting your money in a bank account or putting that same amount of money in a mutual fund? If you go back almost any time in history, you would have been considerably better off putting your money in a mutual fund than you would have been putting it in a bank account.

I guess that is why you are not necessarily doing something not in the customer's best interests to suggest that their money would be better off in a mutual fund.

Mr. FEIGIN. Absolutely not. The question is, what degree of risk are you willing to tolerate. I think we have convinced the American public that putting $100,000 in a bank is an absolute certainty. There is very little gain right now, but there is virtually no risk. It is taking the choice.

Taken to an extreme, if I put my paycheck into lottery tickets and just happen to win, then that return would be fabulous. But was I willing to risk the loss of my paycheck? No.

And it seems that the success of banking and deposit insurance, on the banking side, anyway, has been that as long as interest rates were competitive, people were much happier being insured than they were here.

Chairman NEAL. Of course, even that appears to have broken down, because so many—I mean, huge, trillions of dollars have gone into uninsured instruments. So at least a sizable portion of the public——

Mr. FEIGIN. As I said, we are not opposed to the sale of securities at banks. We think it has to be fair and legal. We are not opposed to the marriage of banks and securities. We are just a little bit concerned or we are trying to make sure that they don't sleep in the same bedroom, I guess.

Chairman NEAL. I don't think there is frankly any disagreement. If a person is informed and then can make an informed decision, then they ought to be able to make that decision. Isn't that right? Isn't that what you think?

Mr. FEIGIN. It is how to enforce that information, or the conveyance of that information. That is the key.

Chairman NEAL. That is what we are trying to get at.

Mr. FEIGIN. What mechanism will give the greatest assurances of it? We have a fully established discipline of securities regulation to see to just that. And the question is, are we going to try and create a new one.

Chairman NEAL. An ad like this was able to be produced and distributed and so on. It is very deceptive. It is not the only one; I imagine there are quite a few.

Mr. FEIGIN. We subscribe to every newspaper in Colorado and look at the ads every day to see if they are deceptive.

Chairman NEAL. Do you find any that are? You must, or——

Mr. FEIGIN. Occasionally. But the idea is those things are offered on those higher rates in the absence of an FDIC logo or the word "bank" or anything like that. People should know it is like going to a casino, because it is not an FDIC-insured bank. If they know they are going to a bank, they are usually getting a different type of product. It is when the two overlap that I think is the problem we are concerned about.

Chairman NEAL. Any other comments? Anyone else?

Anyway, thank you all very much. We appreciate your coming. The subcommittee will stand adjourned.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

APPENDIX

March 8, 1994

STATEMENT OF CHAIRMAN STEPHEN NEAL

Subcommittee on Financial Institutions Supervision, Regulation, and Deposit Insurance
House Banking, Finance, and Urban Affairs

March 8, 1994

It is a pleasure to welcome all of you here this morning. Today the Subcommittee examines the sale of mutual funds by financial institutions.

Banks, through their trust departments, have always been involved with mutual funds, using such funds for investment purposes for trust assets and serving as investment advisors to mutual funds.

Today, however, banks and thrifts have increased their involvement with the retail sale of mutual funds in order to retain customers seeking higher returns on their deposits, as well as to boost fee income. In fact, a recent American Bankers Association survey indicated that 43.8 percent of banks believe selling mutual funds is a high priority, and of those banks that are losing depositors, more than 65 percent said they are losing them to mutual funds.

According to one industry analyst, about 3000 financial institutions sell mutual funds, and the sale of mutual funds through banks and thrifts totaled $409.3 billion for the first half of 1992, the most recent figure available. This figure represents 33 percent of the mutual fund market's total money market fund sales, and 14 percent of all stock and bond fund sales.

Financial institutions sell both shares in mutual funds managed by third party entities, and shares in their own, in-house sponsored funds, known as proprietary funds. Approximately 150 financial institutions currently offer over 1000 of these proprietary mutual funds. According to one estimate, bank proprietary funds constitute one third of all bank and thrift mutual fund

sales and represent 10.7 percent of the overall mutual fund market, up from 8.4 percent of the market in 1992.

I believe bank sales of mutual funds is a good thing for both banks and their customers, but it is important that we establish rules to make sure customers understand that mutual funds are not federally insured products. To that end, we will examine what the banks and the regulators are doing to ensure such customer knowledge.

Two recent consumer surveys highlight these concerns. The first, sponsored by the American Association of Retired Persons, the North American Securities Administrators Association, and the Consumer Federation of America, indicated that 82 percent of financial institution customers did not understand that mutual funds sold by financial institutions are not federally-insured and that 52 percent of purchasers of mutual funds through financial institutions believed that these products were insured by the Federal Deposit Insurance Corporation.

The second survey, sponsored by the SEC, indicated that 30 percent of financial institution mutual fund customers believed that such funds were FDIC-insured.

I am sure we all agree that these numbers are unacceptable.

In addition to the consumer issues, we must ensure that banks and thrifts structure their mutual fund operations so as not to create unacceptable risks to the institution or to the FDIC.

In short, the Subcommittee is holding this hearing to learn more about the involvement of banks and thrifts in the sale of mutual funds and what efforts are being made by federal bank regulators and the financial institution industry to ensure that bank customers are adequately appraised of the risks involved with purchasing mutual funds, and that banks and thrifts structure their mutual fund sales operations in a manner that protects the bank customer as well as the

federal deposit insurance funds.

We also will examine whether legislation is needed to address these concerns. In this regard, I have asked the witnesses to provide their opinions on H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act, introduced by Chairman Gonzalez and Mr. Schumer. We will also receive testimony from Representative Neal of Massachusetts, the sponsor of H.R. 3389, the Depositor Institution Mutual Fund Sales Act.

We will first hear from our distinguished colleague Representative Richard Neal, a former member of this Subcommittee.

We will next hear from the Honorable Andrew Hove, Jr., Acting Chairman of the Federal Deposit Insurance Corporation; the Honorable John P. LaWare, Governor, Board of Governors of the Federal Reserve System; the Honorable Eugene Ludwig, the Comptroller of the Currency; and Mr. Jonathan L. Fiechter, Acting Director of the Office of Thrift Supervision.

Our third panel consists of Mr. R. Scott Jones, Chairman of the Board & Chief Executive Officer, Goodhue County National Bank, Red Wing, Minnesota, and Member of the American Bankers Association Board of Directors; Mr. John Shivers, Chairman/President & Chief Executive Officer of Southwest Bank, Fort Worth,Texas, representing the Independent Bankers Association of America; Mr. Ray Martin, Chairman & Chief Executive Officer, Coast Federal Bank, Los Angeles, California, representing the Savings & Community Bankers of America; Mr. Thomas P. Johnson, Chief Retail Banking Executive, Barnett Banks, Inc., Jacksonville, Florida, and Chairman, Consumer Investments Committee, Consumer Bankers Association; and Mr. Matthew P. Fink, President, Investment Company Institute, Washington, D.C.

Our final panel consists of Mr. Chris Lewis, Director of Banking and Housing Policy,

Consumer Federation of America; Mr. Philip Feigin, Securities Commissioner of Colorado, and President-Elect of the North American Securities Administrators Association; Ms. Tess Canja, Member of the Board of Directors of the American Association of Retired Persons; and Ms. Diane Colasanto, President of Princeton Survey Research.

We have a lot to cover today so I would appreciate it if you could all summarize your testimony. Your complete written statements will of course be made part of the record. I look forward to hearing from all of you.

RICHARD E. NEAL
SECOND DISTRICT, MASSACHUSETTS

WHIP AT-LARGE

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TRADE
SUBCOMMITTEE ON SELECT REVENUE MEASURES

Congress of the United States
House of Representatives
Washington, DC 20515

March 8, 1994

Mr. Chairman, first of all I would like to commend you for holding this hearing on the sale of mutual funds. As banks continue to increase their sale of mutual funds, this hearing is very timely. An impressive group of witnesses have been gathered to provide testimony on the regulation of the sales of mutual funds. Hopefully, this hearing can shed light on a solution that all of us can live with and a solution that will protect consumers.

In the last several months, banks have increased their sale of mutual finds. For the first time in history, assets of mutual funds have exceeded assets of deposits. With the continuation of low interest rates, many consumers are turning to mutual funds for a higher interest rate. More than one third of all banks are now in the business of selling mutual funds.

As former member of this Subcommittee and the Committee on Banking, Finance and Urban Affairs, I have learned that deposit insurance is a confusing issue for may consumers. As we all know, deposits in federally insured depository institutions are covered for the first $100,000. This coverage is limited to certain types of accounts and deposits in different accounts in the same institution can be accumulated towards this amount. The concept is simple enough, but many consumers are confused by the extent and the scope of the coverage.

In the last few years, there have been several bank failures, particularly in the New England area. I have heard from numerous constituents who had more than $100,000 in their accounts. Several of these constituents were not aware of the $100,000 limit. Others were not aware that deposits in accounts in the same institution were accumulated towards the $100,000 limit. This leads me to believe many depositors **are not clear** on which types of deposits are covered by federal deposit insurance.

I have been surprised by the number of consumers who believe any type of investment instrument from a depository institution is covered by federal depository institution. So many people walk into a bank and see the Federal Deposit Insurance Corporation (FDIC) seal in the window and feel their money is completely protected.

131 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-5601

1550 MAIN STREET
FEDERAL BUILDING
SPRINGFIELD, MA 01103
(413) 785-0325

4 CONGRESS STREET
POST OFFICE BUILDING
MILFORD, MA 01757
(508) 634-8198

A few years back, this Subcommittee had a very intense debate on deposit insurance. The issue was limiting the coverage. Deposit insurance was established to protect individuals from bank failures. It was not established to protect sophisticated investors or risky investments. I am not saying that mutual funds are a risky investment, but their protection was not the intent of the establishment of federal deposit insurance. Mutual funds differ from a certificate of deposit and should not be guaranteed the same protection.

Mutual funds are not covered by deposit insurance and this fact has to be made clear to all consumers. Since banks have the protection of federal deposit insurance, they have an obligation to their consumers to notify them of what products are covered by deposit institution. If a bank wants to sell mutual funds, their employees should be trained in this area and notify the customer that the product is not covered by deposit insurance.

In 1993, bank regulators issued four separate sets of guidelines and instructions for banks on the sale of mutual funds. The FDIC released a statement on this issue. The FDIC is concerned depositors may confuse mutual funds with certificates of deposit. Certificates of deposit up to the amount of $100,000 are covered by deposit insurance. Currently, mutual funds are sold without any disclosure that addresses deposit insurance. The sale of mutual funds is conducted in the same manner as accounts covered by deposit insurance. The FDIC believes guidelines are needed in this area.

Recently, several banks have voluntarily let customers know mutual funds are not covered by deposit insurance. This was an important step. However, I believe there should be legislation regulating the sale of mutual funds. I agree with the FDIC that guidelines are needed, but I believe these guidelines should be mandatory.

Last fall, I introduced H.R. 3389, the "Depository Institution Mutual Fund Sales Act." This legislation places two requirements on depository institutions that are selling mutual funds. This legislation amends the Federal Deposit Insurance Act to require insure depository institutions to notify customers who purchase mutual funds on the premise of the institution that mutual funds are not insured deposits. The first requirement is an insured depository institution shall require any person who sells or offers for sale a mutual fund to disclose **in writing** to any person who seeks information about the sale of a mutual fund that they are not insured deposits. The second requirement is an insured depository institution should include in advertisements and promotional periods the information that the mutual fund is not covered by deposit insurance.

At the beginning of this year, the nation's six banking trade associations prepared voluntarily guidelines for bank retail sales of mutual funds and other nondeposit investment products. The guidelines are intended to complement the guidelines released by bank regulators. The guidelines adequately address oral and written disclosures, advertising and promotion, location, and training of employees. I commend the trade associations for their efforts. I believe the guidelines are appropriate and would eliminate confusion among consumers. However, I am concerned that all institutions will not adhere to guidelines. Also, once the sale of mutual funds fades from the limelight, banks may stop following the guidelines.

The sale of mutual funds by banks should not create additional paper work for banks. However, if banks want to sell this product they should be required to notify the customer that mutual funds are not insured deposits. H.R. 3389 simply requires the banks to notify the customer in writing. After that point, it should be up to the customer to be responsible for the decision. Banks should just be required to be legally responsible for disclosing the information.

I strongly agree with the guidelines issued by the six banking trade associations, but I believe the disclosure recommendation needs to be enacted into law. However, banks who sell mutual funds should adhere to all the guidelines and recommendations from the trade associations and the bank regulators.

Thank you for allowing me to testify before this Subcommittee. I hope we can all work together to clear up the confusion on the sale of mutual funds.

REMARKS OF
CONGRESSMAN CHARLES E. SCHUMER
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND DEPOSIT INSURANCE
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

MARCH 8, 1994

I want to acknowledge Chairman Neal's initiative in scheduling this hearing on bank sales of mutual funds. As you know, I consider this to be an issue of utmost importance and urgency to consumers of bank services as well as to the safety and soundness of banks and the deposit insurance funds, especially in the event of a stock or bond market crisis.

I hava introduced legislation, H.R. 3306, which is co-sponsored by Chairman Gonzalez. This bill is designed to correct the shortcomings that have existed so far when banks sell mutual funds and other non-insured investment products to customers without full and accurate disclosure that these products are different from traditional insured bank products. I appreciate Chairman Neal's request to those testifying before us today that they comment on H.R. 3306. I believe strongly that this bill ie good both for consumers and for banks.

Why do we need legislation to ensure that banks meet their disclosure obligations in the sale of mutual funds and other non-insured investment products? As survey after survey

has shown, and as witnesses have underscored in their testimony today, far too many bank customers are not aware -- even after they purchase mutual funds from banks -- that, unlike their bank deposits, their mutual fund investments are not insured by the federal government. Even the principal that bank customers invest in non-insured products is at risk -- it may actually lose value.

It is not surprising that bank customers do not easily understand the subtle differences between insured and non-insured investment products sold by banks. For over 60 years, ever since federal deposit insurance was created in the aftermath of the run on banks and the Great Depression, Americans have been encouraged to believe that the money that they place in banks is protected by the federal government up to the deposit insurance limit.

Since the 1930's, we have nourished the presumption that federal deposit insurance protects and preserves the money that customers entrust to their banks. It is no wonder that this presumption endures in the minds of so many bank customers. As one witness has pointed out today, the FDIC logo has become the "symbol of security" for the American banking public.

But times and bank products are changing. Today, banks are selling new, non-insured products alongside their traditional insured deposits. Today, sometimes the money that consumers place in banks is insured by the federal government, sometimes it

is not, depending on what financial product the customer chooses to buy.

We should not be surprised that bank customers are confused. We should not be surprised that the presumption of deposit insurance persists. We should not be surprised that survey after survey bears out the persistence and strength of the deposit insurance presumption. We should -- must -- do something to overcome this presumption.

What we need to do to successfully overcome such a strong and persistent presumption in the minds of American consumers is to ensure that banks give strong, clear and effective disclosure. Banks' disclosure message must be loud and clear: first, even though non-insured investment products and insured deposits both are available inside the same federally insured bank with the FDIC logo on the door, mutual funds and other non-insured investments are different from CD's and other insured deposits; second, they are different in serious and possibly negative ways that could materially influence the choice of every properly informed investor.

The full disclosure message that banks must deliver about non-insured investment products must not be undercut by conflicting information that tends to reinforce the presumption

of deposit insurance. For example:

- Tellers and others who accept insured deposits must not sell uninsured non-deposit products.
- Uninsured products need to be sold in a part of the bank that is physically separated from the part of the bank associated with accepting and withdrawing deposits.
- Banks should not be permitted to sell mutual funds with names that are so similar to the name of the bank that they reinforce the expectation of deposit insurance.
- Personnel must be properly trained on matters of suitability and disclosure, and not have their judgement about what investment advice to give distorted by incentive compensation schemes that reward selling uninsured products at the expense of suitability and adequate disclosure.

No one, including those testifying today, seriously contends that current disclosure by banks is adequate. That is why Congress needs to act. If all the recent surveys and today's testimony tell us anything, it is that voluntary "guidelines" issued by banking regulators and industry groups are simply not up to the job. Customer confusion persists. The distinctions

between insured and non-insured products are being blurred. The guidelines are not being followed, are not being effectively enforced and often don't go far enough to ensure that the presumption of deposit insurance is overcome in the minds of bank customers. Required disclosure must have the force of law.

TESTIMONY OF

ANDREW C. HOVE, JR.
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

BANK SALES OF MUTUAL FUNDS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND DEPOSIT INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

10:00 A.M.
MARCH 8, 1994
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman and members of the Subcommittee, I am pleased to have this opportunity to testify on bank sales of mutual funds. We believe this is a timely subject and commend your efforts to develop the public record on this important issue.

Sales of nondeposit investment products on bank premises are not something that is new to FDIC-supervised institutions. For instance, the savings bank life insurance programs in Connecticut, New York and Massachusetts long have included the sale of annuities, and discount brokerage services have been offered by some banks for a number of years. Banks also have been involved in securities transactions through trust department activities and have operated common trust funds for customer accounts. The sale of commercial paper and "retail repos" on bank premises has received close scrutiny for years. These services and products have been offered without any detrimental effect on the financial condition of the banks and with minimal consumer complaint.

The FDIC has had in place since 1984, Section 337.4 of its Rules and Regulations which deals with securities activities of subsidiaries of insured nonmember banks and bank transactions with affiliated securities companies. The regulations establish operating rules for banks having such subsidiaries, including disclosure provisions and controls over intercompany transactions. In particular, if a subsidiary is engaged in any securities activity which the bank cannot engage in directly, the

bank's compliance with regulatory capital standards is measured on an unconsolidated basis, i.e. the bank's investment in the subsidiary would be deducted before measuring capital. Attachment A provides a detailed description of our regulation.

Bank retail sales of mutual funds have grown considerably i recent years. We estimate that at least one-third of the banks which FDIC supervises have involvement in sales of nondeposit investment products. Bank involvement in the sale of mutual funds is a part of the continuing evolution of the delivery of these products in this country. The convenience of banking facilities for customers make banks the natural site for the delivery of a range of financial products including sales of mutual funds.

Any industry that is undergoing rapid change must be monitored carefully since rapid growth is sometimes accompanied by lapses, abusive practices, or programs that outgrow management's capabilities. The familiarity of the bank surroundings can give customers both the sense of security to inquire about products which may be unfamiliar to them as well a: a false sense of security about the safety of their investments.

The federal financial institution regulators have issued to banks and bank examiners substantive guidance on the standards and procedures for prudent bank involvement in the sale of

nondeposit products and for identifying and correcting abuses. The banking industry itself has issued guidelines for self policing. However, an important question remains as to how banking agency supervision of bank sales of mutual funds interfaces with traditional securities industry supervision. Both bank and securities regulators are concerned that the customer be protected from abusive practices, and that expansio of the financial products offered by banks not be bogged down i duplicative supervision and regulation.

Recent surveys and reports indicate that the degree of confusion among consumers with respect to bank sales of mutual funds is unacceptably high. This confusion is due in part to tl failure of some banks to follow the best practices and guidance provided by the regulators and banking trade groups. For this reason, we are launching three new initiatives. As we describe in more detail below: 1) the FDIC proposes that all bank personnel selling mutual funds be subject to the same training and examination requirements as those who do not work for a bank 2) the FDIC will issue a brochure to be provided to purchasers c mutual funds that clearly describes the difference between insured and uninsured bank products and the differences between FDIC insurance and other forms of insurance (e.g., SIPC); and 3) the FDIC will initiate a pilot program of on-site testing to determine industry compliance.

Recent Guidelines Address Concerns

The FDIC concerns about bank sales of mutual funds are in two major areas: customer confusion and management of the sales program. The FDIC and the other bank regulatory agencies have issued guidelines to address these concerns.

On October 8, 1993, the FDIC issued a "Supervisory Statemen Regarding State Nonmember Bank Sales of Mutual Funds and Annuities." Other agencies issued similar statements to the institutions they supervise. The statement served as guidance t state nonmember banks relating to the FDIC's concerns about bank sales of mutual funds and annuities. Our examiners have been examining for compliance with these guidelines. On February 19, 1994, we joined with the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Reserve Board in issuing an "Interagency Statement on Retail Sales of Nondeposit Investment Products" which superseded our original statement. Both statements advise banks to develop policies and practices to address specified supervisory concerns we have outlined.

The guidelines serve as notice to bankers as to what, in the opinion of the regulators, constitutes safe and sound practices with respect to mutual fund sales. If, for example, bank employees misrepresent the safety of the investment or

mislead customers to believe that the mutual fund is insured by the FDIC, such misrepresentation constitutes an unsafe and unsound practice and under Section 8 of the FDI Act the institution could be subject to a broad array of enforcement powers and civil money penalties. In addition, the regulators can also enforce banks' compliance with any laws and regulations with regard to securities.

Customer Confusion

There have been a number of recent surveys and studies indicating that customers are confused about mutual fund investments, especially if purchased at a bank. The confusion centers on the nature of the product and the question of who is ultimately responsible if there is a loss in the investment. Poor explanations by some bank staff also appear to be at fault. To counter these problems, the financial institutions regulators have stated in our guidance that banks engaged in sales of nondeposit investment products should disclose to the customer that the product is not insured by the FDIC, is not a deposit or other obligation of the institution, is not guaranteed by the institution, and is subject to investment risks, including possible loss of the principal invested. We believe that these disclosures given orally during sales presentations and when investment advice is provided, and in writing prior to or at the time an investment account is opened can help reduce customer

misconceptions concerning who is ultimately liable if there is a loss in the investment. Appropriate disclosures should also appear in periodic statements to customers.

Advertising and other promotional materials about nondeposit investment products should conspicuously include the appropriate disclosures. Any advertising or promotional material by third party vendors on bank premises should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller if it is not. The FDIC is also concerned that the customer be informed of any advisory relationship that a bank has with a particular mutual fund.

The FDIC expects these disclosures to be clear, concise and conspicuous. We have found banks and their trade associations to be quite supportive of this effort. Our examination experience since the implementation of the supervisory guidance indicates that most banks have been conscientious in attempting to insure that customers purchasing nondeposit investment products receive appropriate disclosures. Where our examiners have found deficiencies, banks have taken steps to correct problems.

Although we consider disclosure to be the centerpiece in any program to eliminate customer confusion, the FDIC also has taken strong positions concerning the setting and circumstances in

which the sale of nondeposit investment products should occur on a bank's premises. We believe that having a physically distinct sales area for nondeposit investments is necessary in order to deter customer confusion. We expect banks to develop and implement policies that ensure that purchasers of nondeposit investment products are not lured by false, incomplete or misleading promotions. Once in the bank, the physical location of the sale should be distinguished in a manner that causes a customer to recognize that they are considering something other than a traditional deposit or bank product.

Our guidance also addresses concerns about the personnel selling these nondeposit products. Whether the salesperson works for the bank, is a dual employee of the bank and a third party broker/dealer, or is in the bank representing a third party broker/dealer, the person must have received adequate training relative to the products being sold. Employees who are representing third-party vendors should clearly inform customers for whom they are working. Because of the significant possibility for customer confusion, tellers should not be involved in selling investment products or offering investment advice. The bank should train all customer contact persons, even those who are not involved in the sales of nondeposit investments, to make sure they understand the bank's policy. That policy must limit employees who are not authorized to sell

investment products to referring customer inquiries to trained sales representatives.

Bank Management Responsibilities

While customer confusion issues have received much public attention, the FDIC is also concerned with the bank's management and administration of its nondeposit investment sales program. Banks involved in the sales of nondeposit investment products should adopt policies and procedures for their sales program, including establishing qualitative standards for the selection and review of each type of product sold or recommended. Prudent management concerns necessitate a bank developing a well thought out program for the sale of these products which includes adopting reasonable standards for the products recommended in the sales program.

We also expect that banks will conduct an appropriate review of any third party who may contract with the bank to offer these products to the bank's customers. These arrangements should be in writing and establish the responsibilities of both the bank and the third party. In the banks which the FDIC supervises, third party broker/dealer arrangements are a very common method of offering nondeposit investment products to their customers. It is the bank's responsibility to review these third parties to ensure that the program offered meets their customers' needs and

complies with the agency guidelines, the bank's own policies and procedures and the bank's contract with the third party. This contract should specify that the third party will comply with all applicable laws.

In addition to ensuring that appropriate products are offered and vendors meet the bank's standards, any program to sell nondeposit investment products should be designed to ensure that the products offered are suitable for the individual customer's needs. Banks should maintain documentation to reflect the bank salespersons' reasons for recommending a product to a particular customer, and in doing so reasonable inquiry should be made into a customer's financial condition, background, tax status and investment objectives.

Banks compensation programs should not compromise an employee's judgment of a product's suitability by providing greater compensation when an unsuitable product is sold. In addition, to avoid undue pressures on customers, employee referral programs should be based solely on the referral and not on whether the referral resulted in a sale and should be limited to a one-time nominal fixed dollar amount.

A properly structured nondeposit investment product sales program can benefit not only the customer, through convenient locations at which to shop, but also the bank which may be able

to forge stronger bonds with its customers by meeting more of their financial needs. The additional initiatives we are announcing today will enable the FDIC to provide effective supervisory guidance to ensure banks conduct these programs in a safe and sound manner and avoid customer confusion. The bank supervisory function enables the FDIC to review bank sales programs on a regular basis and enforce standards when misleading or abusive practices are found.

New Regulatory Initiatives

Our examiners report that we are finding that banks are responding positively to the concerns of customers and regulators. For example, in a recent well publicized case, a bank decided to change the names of its advised mutual funds to resolve FDIC concerns that the similarity of the name of the mutual funds with the bank's name could create customer confusion.

During February of this year, six bank trade associations jointly issued retail investment sales guidelines for their member institutions. The Federal financial institution regulators worked closely with the associations in writing these guidelines. They generally parallel, reiterate, and emphasize the guidance issued by the Federal financial institution regulators. The industry's guidance recognizes that consumers

need to be educated and informed concerning the risks and rewards of investing and that institution programs must be competently managed.

The FDIC is not content, however, with the actions taken to date and will continue to actively monitor bank sales of mutual funds. Despite our efforts so far, it appears that there continues to be customer confusion. We are committed to ensuring that no bank exploits the confusion that often confronts consumers when they purchase financial products. Some commentators have suggested that this customer confusion is a time bomb which will explode into liability for banks and possibly the FDIC when there is a significant stock market downturn. We continue to be concerned about, and will strive to avoid, such possibilities.

We will be preparing an FDIC approved and authorized brochure describing and discussing the distinctions between FDIC insured and uninsured bank products in clear language. The brochure will be made widely available directly to consumers and we will direct bank sellers of mutual funds and other non-deposit products to provide it to customers as part of their disclosure material. If necessary, we will issue a regulation mandating compliance.

We also believe that all persons selling mutual funds be subject to the same training and examination requirements -- whether they work for a bank or not. We therefore, will be exploring with the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD), as well as the other banking regulators, how that can be accomplished.

Finally, the FDIC will commission a formal on-site testing program. Under this program, we will use testers to see what institutions are actually telling customers in sales presentations and in response to inquiries. This program will serve two purposes in that it will provide us with information regarding any systemic problems as well as triggering corrective action in any cases where we discover a problem.

In addition, the three Federal banking agencies have adopted changes to bank Call Reports to identify banks that are involved in sales of mutual funds and annuities, the dollar volume of their sales by product type, and the contribution these sales activities make to bank earnings. This sales and income information will be used in the supervisory process to alert examiners and others at an early stage to significant changes in a bank's operations. These changes will be implemented for the first time as of the March 31, 1994 reports.

Pending Legislation

H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act, addresses many of the same issues addressed in the interagency statement, though, in a much more prescriptive manner. The proposed legislation envisions the Federal financial institution regulators actively prescribing, among other things, the exact form of customer disclosures, rules of fair practice for sales, qualifications and training standards for persons involved in sales and compensation standards. The FDIC believes that the major thrust and provisions of the legislation are consistent with agency guidance that is already in place. The major question that remains is whether locking in the guidance in a fairly rigid way is appropriate and the best way to handle the problems that may yet occur in an evolving area, particularly given the initiatives already taken by the Federal financial institution regulators and the industry trade groups. It may be worth noting that many of the standards followed by the securities industry in these areas have been established by the NASD, a self-regulating body, rather than by SEC regulators.

The FDIC has resisted developing detailed regulations of this type up to this point because of the broad and varied nature of the products to be covered, the fact that bank programs are new and evolving, and our desire to allow the private sector to

develop product lines and programs desired by bank customers so long as certain important principles, such as safe and sound operation and avoidance of potential customer confusion, are assured. The legislation attempts to establish a bright line and mandatory policy on all issues regarding sales of all kinds of nondeposit investment products.

We have a number of concerns about trying to legislatively prescribe a rule for every issue discussed in the interagency statement. For example, the bill requires the federal banking agencies to jointly determine appropriate training standards for bank personnel who sell nondeposit investment products who are not registered broker/dealers. But, training that is appropriate for sales of mutual funds is not the same training received for sale of other products.

The same concerns exist with specifying disclosures and developing rules of fair practice. Rules of fair practice based on NASD standards may not make sense for such products as fixed rate annuities. We are also concerned about the rigidity of the disclosure and setting and circumstance requirements, and the apparent diminution of the agencies' authority in these areas.

The most difficult of the regulatory standards the legislation would require concerns compensation programs. The banking industry has historically compensated its employees by

salaries and bonuses. The securities and insurance industries compensate their employees to a significant extent based on sales commissions. If persons in a bank receive a commission for selling a security or insurance product and no commission for opening or renewing a deposit, then the seeds for conflicts of interest have been planted. It is unrealistic to expect securities or insurance sales persons that operate in a bank to be compensated in a manner other than the industry norm. On the other hand, allowing differing compensation programs is not in the best interest of the bank or its customers. We continue to believe that the best method of handling this problem is to have the regulator's determine whether a bank's compensation schedule is safe and sound, involves a conflict of interest or otherwise violates applicable law.

Conclusion

In summary, the FDIC will prepare and distribute a plain English brochure describing and discussing the distinctions between FDIC insured and uninsured bank products; require all persons selling mutual funds to be subject to the same training and examination requirements as non bank sellers of mutual funds; and, initiate a testing program.

At this time, we believe that the financial institution regulators are taking action that will be effective in providing

a framework for the sale of mutual funds on bank premises which can provide consumers with adequate information and protection as well as limit the bank's liability and thus the exposure of the deposit insurance funds. We believe that the new initiatives that we are announcing today will also provide additional protection to consumers and identify remaining problems. I can assure you that the FDIC will not hesitate to take stronger action, including recommending strict regulation of the business, if we find abusive practices are widespread. As discussed earlier, we are prepared to use our array of enforcement tools on individual situations needing correction. For this reason, we believe that legislation would be premature at this point in time.

This concludes my formal testimony. I would be pleased to respond to any questions Members of the Subcommittee may have.

ATTACHMENT A

SUMMARY OF PART 337.4 OF
FDIC RULES AND REGULATIONS

SECURITIES ACTIVITIES OF SUBSIDIARIES OF
INSURED NONMEMBER BANKS, BANK TRANSACTIONS
WITH AFFILIATED SECURITIES COMPANIES

On December 28, 1984, the FDIC implemented its regulation on securities activities of subsidiaries of insured nonmember banks and bank transactions with affiliated securities companies. The regulation is codified at 12 C.F.R. § 337.4. At that time, the FDIC determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities if authorized under state law. At the same time, the FDIC found that some risk may be associated with those activities. In order to address that risk, the FDIC regulation (1) defines bona fide subsidiary, (2) requires notice of intent to acquire or establish a securities subsidiary, (3) limits the permissible securities activities of insured nonmember bank subsidiaries, and (4) places certain other restrictions on loans, extensions of credit and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities. Each of these issues is discussed below.

The term "bona fide" subsidiary means a subsidiary of an insured nonmember bank that at a minimum: (1) is adequately capitalized, (2) is physically separate and distinct in its operations from the operations of the bank, (3) maintains separate accounting and other corporate records, (4) observes separate corporate formalities such as separate board of directors meetings, (5) maintains separate employees who are compensated by the subsidiary, (6) shares no common officers with the bank, (7) a majority of the board of directors is composed of persons who are neither directors nor officers of the bank, and (8) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

This definition is imposed to ensure the separateness of the subsidiary and the bank. This separation is necessary as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. Also, the separation safeguards the soundness of the parent bank.

The regulation provides that the insured nonmember bank must give the FDIC written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummating the acquisition or commencement of the operation of the subsidiary. These notices serve as a supervisory mechanism to apprise the FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries that pose potential risks to which the bank otherwise would not be exposed.

Activities of the subsidiary are limited in that it may not engage in the underwriting of securities that would otherwise be prohibited to the bank itself under the Glass Steagall Act unless the subsidiary meets the bona fide definition and the activities are limited to (1) underwriting of investment quality debt securities, (2) underwriting of investment quality equity securities, (3) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than investment quality debt securities and/or investment quality equity securities, or (4) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than obligations of the United States or United States Government agencies, repurchase agreements involving such obligations, bank certificates of deposit, banker's acceptances and other bank money instruments, short-term corporate debt instruments, and other similar investments normally associated with a money market fund.

A subsidiary may engage in underwriting other than that listed above if it meets the bona fide definition and the following conditions are met:

(a) The subsidiary is a member in good standing of the National Association of Securities Dealers;

(b) The subsidiary has been in continuous operation for the five-year period preceding the notice to the FDIC;

(c) No director, officer, general partner, employee or 10 percent shareholder has been convicted within five years of any felony or misdemeanor in connection with the purchase or sale of any security;

(d) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders is subject to any state or federal administrative order or court order, judgment or decree arising out of the conduct of the securities business;

(e) None of the subsidiary's directors, officers, general partners, employees or 10 percent shareholders are subject to an order entered within five years issued by the Securities and Exchange Commission pursuant to certain provisions of the Securities and Exchange Act of 1934 or the Investment Advisors Act of 1940; and

(f) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

A bank's investment in a subsidiary engaged in securities activities that would be prohibited to the bank under the Glass-Steagall Act is not counted toward the bank's capital, i.e., the investment in the subsidiary is deducted before compliance with capital requirements is measured.

An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures or notes, or other securities, or acts as an investment advisor to any investment company may not engage in any of the following transactions:

(1) Purchase in its discretion as fiduciary any security currently distributed, underwritten or issued by the subsidiary unless the purchase is authorized by a trust instrument or is permissible under applicable law.

(2) Transact business through the trust department with the securities firm unless the transactions are at least comparable to transactions with an unaffiliated company.

(3) Extend credit or make any loan directly or indirectly to any company whose obligations are underwritten or distributed by the securities firm unless the securities are of investment quality.

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are underwritten or distributed by the securities company.

(5) Extend credit or make any loan where the purpose of the loan is to acquire securities underwritten or distributed by the securities company.

(6) Make any loans or extensions of credit to a subsidiary or affiliate of the bank that distributes or underwrites securities or advises an investment company in excess of the limits and restrictions set by section 23A of the Federal Reserve Act.

(7) Make any loan or extension of credit to any investment company for which the securities company acts as an investment advisor in excess of the limits and restrictions set by section 23A of the Federal Reserve Act.

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with the banks securities company to underwrite or distribute the company's securities or condition a loan to a person on the requirement that the person purchase any security underwritten or distributed by the bank's securities company.

An insured nonmember bank is prohibited from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the operation of the bank; (2) the bank and the affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors or officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities of the affiliate on the premises of the bank that involve customer contact; and (5) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank. The FDIC has chosen not to require notices relative to affiliates because we would normally find out about the affiliation in a deposit insurance application or a change of bank control notice.

For Release on Delivery
10:00 a.m. EST
March 8, 1994

Testimony of

John P. LaWare

Member, Board of Governors of the Federal Reserve System

Before the

Subcommittee on Financial Institutions Supervision, Regulation

and Deposit Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

March 8, 1994

I am pleased to appear before the Financial Institutions Subcommittee today on behalf of the Federal Reserve Board to describe the actions the Board has taken to regulate bank sales of mutual funds and to present the Board's views on what additional regulatory or Congressional action is necessary.

Growth of Mutual Funds

Before describing the actions the Board has taken, I would like to make some observations about the recent growth in the mutual fund industry. Growth in mutual fund assets in recent years has been nothing short of explosive. Last year, the public bought a record $294 billion shares of mutual funds, nearly all of which was in stock and bond funds, bringing assets under management in the mutual fund industry to slightly over $2.0 trillion at year-end. As a consequence, mutual fund assets have surpassed the life insurance industry in size and, today, are exceeded only by commercial banks and pension funds. The strong inflows into mutual funds reflect their popularity among households. It is estimated that nearly a fifth of all households own shares in at least one mutual fund.

As mutual funds have become a significant competitor to depository institutions, these institutions have increased their participation in the mutual fund industry. The net assets of bank proprietary mutual funds are estimated to have increased from $44 billion at the end of 1988 to $220 billion at the end of 1993. Between 1988 and 1993, the market share of bank

proprietary funds doubled from 5 1/2 percent to over 10 percent of the total mutual fund industry assets.

The potential for customer confusion clearly exists when mutual funds are sold to the public by depository institutions, given their traditional insured deposit activities. The chief concern is that depositors may not understand that the mutual fund investments they buy from a depository institution are not deposits and are not covered by FDIC insurance. There is also the possibility that depository institution customers who buy mutual funds may receive less than adequate investment advice about mutual funds if sales personnel are not properly trained or their sales practices are not properly supervised.

This potential for customer confusion involving mutual fund sales could adversely affect the safety and soundness of a depository institution. If depositors suffer losses on investments they have purchased from a depository institution, the institution's reputation, and possibly its financial condition, could be adversely affected. More specifically, litigation risk and possible deposit withdrawals could affect a bank unfavorably.

Board Actions Regarding Involvement by Banking Organizations with Mutual Funds

The Board takes these concerns seriously. Over the years, the Board and its staff have issued a number of interpretive opinions, supervisory letters, and informal staff opinions addressing issues relating to bank sales of uninsured

investment products, including mutual funds. Many of these statements have been issued either in connection with the authorization of additional activities for bank holding companies or when the Board and its examiners have concluded that regulatory guidelines are necessary to address the manner in which an activity is being conducted. All of these statements reflect the Board's longstanding policy that when banks sell uninsured investment products to their customers, they should do so in a manner that clearly distinguishes these products from insured deposits.

The first regulatory action that the Board took concerning mutual funds was a 1972 interpretive rule relating to conflicts that may arise when a bank holding company acts as an investment adviser to mutual funds. This rule authorized bank holding companies to act as investment advisers to mutual funds and, at the same time, created safeguards designed to assure a separation between the mutual fund being advised and the holding company's subsidiary banks.

During the mid-80's, as bank holding companies and banks received authorization to engage in discount and full service brokerage, the Board and its staff, through orders, opinion letters, and informal staff interpretations, adopted disclosure requirements that are applicable when these powers are used by banks and bank holding companies to sell mutual funds. Pursuant to these requirements, bank holding companies and banks are required to inform a customer that investments in a fund's

shares are not obligations of a bank and are not insured by the FDIC. More recently, the Board revised its 1972 rule regarding investment advisory activities of bank holding companies to require that banks that sell or provide investment advice about mutual funds that are advised by an affiliate must disclose to customers the relationship between the affiliate and the fund.

Interagency Guidelines

In response to the rapidly growing involvement of depository institutions in the sales of mutual funds, the Board and the other bank regulatory agencies last month jointly issued a comprehensive set of guidelines governing the retail sale of mutual funds and other nondeposit investment products by depository institutions.

I would like today to focus on those aspects of the statement that are intended to address directly the question of potential customer confusion regarding the uninsured status of mutual funds and similar investment products, their nondeposit character, and the risks inherent in investing in such products. Assuring that customers are not confused about the products they are purchasing is not simply a matter of providing accurate disclosure. Experience has demonstrated that the "manner" in which products are sold -- the location of the sales, the experience and training of the personnel selling the products, and the conduct of sales programs -- all contribute to the customer's understanding of the nature and risk associated with their investments.

A. Disclosure

In developing the interagency guidelines, one of the goals of the agencies was to standardize the basic disclosures that banks provide customers about mutual funds and other uninsured investment products. The disclosures provided for by the interagency statement must, at the very minimum, indicate that the product is not insured by the FDIC, is not a deposit or other obligation of, or guaranteed by, the selling depository institution, and is subject to investment risks, including possible loss of the principal amount invested. These disclosures should be provided orally during any sales presentations or when investment advice is given; orally and in writing prior to or at the time an investment account is opened; and must be contained in all advertisements and other promotional materials. When the disclosures are provided in writing, they should be conspicuous and presented in a clear and concise manner. A depository institution also should disclose the existence of any advisory or other material relationship between the institution, or an affiliate of the institution, and a mutual fund whose shares are sold by the institution. Any other material relationship between the institution and an affiliate involved in providing the investment products should also be disclosed.

The agencies also provide for a disclosure concerning the Securities Investor Protection Corporation ("SIPC") and other forms of insurance when mutual funds are sold by broker-dealers

on bank premises. The interagency guidelines specifically state that if sales activities include any written or oral representations concerning insurance coverage provided by SIPC or any other insurance fund or company, then a clear and accurate explanation of the coverage must be provided. There should not be any suggestion or implication that an alternative form of insurance coverage is the same or similar to FDIC insurance of bank deposits.

The interagency guidelines also provide that advertisements and other promotional and sales materials conspicuously include at least the minimum disclosures and must not suggest or convey a misleading impression about the nature of the investment product or its lack of FDIC insurance. The minimum disclosures also should be emphasized in telemarketing contacts. Written materials that contain information about both FDIC-insured deposits and nondeposit investment products should clearly segregate the two types of information.

B. Location of Sales

In order to further minimize the potential for customer confusion, the interagency guidelines provide that, except in very limited situations where physical considerations prevent it, sales or recommendations relating to nondeposit investment products should be conducted in a physical location distinct from the area where retail deposits are taken.

C. Personnel

Another element that must be considered in minimizing the potential for customer confusion relates to the personnel who provide advice about, or sell, mutual funds or other nondeposit investment products. The interagency guidelines provide that tellers and other employees should not make general or specific investment recommendations or accept orders for nondeposit investment products, even if unsolicited, while located in the routine deposit taking area. Tellers and other employees who are not authorized to sell nondeposit investment products may only refer customers to individuals who are specifically trained to sell nondeposit investment products.

The interagency guidelines provide that depository institution personnel who sell, or provide investment advice about, nondeposit investment products should receive training that is the substantive equivalent of the type of training required for brokers licensed by the National Association of Securities Dealers ("NASD"). In addition, a depository institution should provide training to its employees who may have direct contact with customers to ensure a basic understanding of the institution's sales activities and the limits on their involvement in selling such nondeposit investment products.

D. Suitability

The guidelines also provide that depository institution personnel who recommend nondeposit investment products should have reasonable grounds for believing that a specific product is

suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful in making an investment recommendation. Personnel who are authorized to sell nondeposit investment products may receive incentive compensation for transactions entered into by customers; however, incentive compensation programs should not be structured in such a way as to result in unsuitable recommendations.

Board Supervision of Mutual Fund Activities

With regard to possible congressional action regarding mutual fund activities by banking organizations, the fact that the substantive provisions of H.R. 3306 are essentially mirrored in the agencies' guidelines reduces the need for legislative action at this time. If a depository institution or any of its employees do not follow the guidelines, the regulators have ample authority to address any unsafe and unsound practices regarding the sale of mutual funds by depository institutions and to sanction misconduct where appropriate.

The Federal Reserve is also augmenting its current examination procedures regarding sales of mutual funds by state member banks or affiliated broker-dealers to assure that the guidance contained in the recent interagency statement is being heeded. Sales of mutual funds by State member banks

traditionally have been supervised and examined by the Federal Reserve in the same manner as sales of other securities and nondeposit, uninsured financial instruments. Before the adoption of the interagency statement, the Board in June 1993 issued specific supervisory guidance for examiner use concerning proper disclosure and the separation of mutual fund sales from deposit taking activities on bank premises. Over the years, the Federal Reserve has developed product-specific examination procedures to ensure that these activities are carried out in a safe and sound manner. Further, the procedures are intended to address the Board's commitment to adequate disclosure of the uninsured nature of these retail investment products. Federal Reserve examiners have been reviewing on a regular basis the sales practices associated with uninsured, nondeposit investment instruments for compliance with our policies.

Prior to the issuance of the interagency statement, the Board assembled an inter-district task force composed of senior examiners who have experience supervising and examining brokerage affiliates of banks and bank holding companies. That task force has been revising and expanding the Board's existing securities examination procedures to incorporate specifically the interagency statement. Currently, the task force is field-testing and refining the expanded procedures at an examination of a large regional bank holding company and its securities affiliate that is actively involved in sales of mutual funds on the subsidiary banks' premises. Upon completion of the

examination within the next several weeks, the task force will assemble in Washington, D.C. to finalize the revised mutual fund examination procedures and they will be implemented immediately thereafter.

To avoid unnecessary regulatory burden on banks and affiliated broker-dealers, and in recognition of the expertise developed by the securities self-regulatory organizations, the Board initiated discussions with the NASD pertaining to its examinations of bank affiliated broker-dealers. The NASD examines bank affiliated broker-dealers for compliance with its rules regarding sales practices, recordkeeping and other applicable customer protection requirements. Based on an informal survey of our Reserve Banks, we understand that about 85 percent of those State member banks that sell mutual funds do so through a registered broker-dealer selling on bank premises. About half of these registered broker-dealers are bank affiliated. All registered broker-dealers are subject to SEC oversight and to the additional requirements and rules adopted by their self-regulatory organizations.

Our discussions with the NASD have focused on cooperative efforts to minimize unnecessary duplication of examination efforts. These initiatives include examiner support and possible information sharing regarding bank affiliated broker-dealers. In this regard, an NASD examiner went on-site with our examiner task force in field testing our mutual fund examination procedures.

Aside from new examination initiatives, the Board is considering expanding the scope of the consumer education seminars now being offered by the Federal Reserve Banks around the country to address specifically consumer issues related to mutual funds.

Conclusion

The issues raised by this hearing today are of extreme importance to both consumers who are faced with increasingly complex choices about investments and savings, and to banks that must address their customers' need for access to a variety of investment and savings vehicles. Saving for a college education or for retirement is no longer as simple as depositing a set amount in a bank account each week. We believe that banks are in a unique position to help consumers understand the choices before them. But banks must recognize and affirmatively address the potential for customer confusion and the need to provide consumers with complete and accurate information. We intend to take all actions within our power to ensure that the depository institutions subject to the Board's jurisdiction do so. Selling mutual funds and other investment products in a manner that is not misleading and that provides customers with accurate and complete information is an important element of safe and sound banking which we intend to enforce.

Recent Trends in the Mutual Fund Industry

Phillip R. Mack, of the Division of Research and Statistics, prepared this article. Michael A. Schoenbeck provided research assistance.

Mutual fund assets have grown more than twelvefold from 1980 to mid-1993 and by half in the last two years of that period. Most of this growth has come from net purchases of fund shares by the public, rather than from price appreciation, and it has lately reflected a choice by investors to move funds out of depository institutions. In 1992, the public made net purchases of $206 billion of mutual fund shares, while making net withdrawals from their deposits at banks and thrift institutions. In turn, mutual funds supplied about one-fourth of funds raised by the domestic nonfinancial sectors of the economy last year, while depository institutions provided only about one-tenth. In short, mutual funds are now a significant competitor of depository institutions for household savings and, with more than $1.8 trillion in assets, they are a major source of funds in the capital markets.

Several factors underlie the recent surge in mutual funds. One is the drop in rates on deposits—especially short-term deposits—to relatively low levels at a time when rising stock and bond prices have been generating higher returns. As a result, households seeking to maintain satisfactory returns on their savings have been drawn to capital market instruments, especially mutual funds, whose diversification and liquidity offer advantages over direct investments in securities. In addition, the benefits of economies of scale in the mutual fund industry have been shared with investors through a widening array of services provided by fund families. Finally, many funds have eliminated or substantially reduced the sales commissions, or loads, they charge to investors.

Corporations with access to the capital markets, including firms with lower credit ratings, have benefited from the expanded supply of investment dollars represented by the surge in mutual funds. State and local governments also have benefited, with inflows to tax-exempt mutual funds running at a record pace since the end of 1992. Moreover, in recent years, smaller corporations raising equity through initial public offerings, as well as established firms, have seen mutual funds purchase a significant portion of the new equity they have sold.

In response to the growth of the funds industry, banks have increased their participation in the provision of mutual fund services. For example, many banks sell mutual fund shares to their retail customers and, in some cases, act as an investment adviser to mutual funds and provide other related services. The increased involvement of banks has brought attention to their role in the sale of mutual fund shares, including their responsibility for ensuring that customers are made aware of the differences between mutual fund shares and insured deposits.

The expanding role of mutual funds has had at least two important implications for the performance and structure of the financial markets. By offering households more diversified investment opportunities and corporations a greater market for their financial instruments, mutual funds have improved the efficiency of financial intermediation by reducing transaction costs. And as intermediaries competing with banks and thrift institutions, mutual funds have contributed to the reduction of the role of these depositories as providers of credit in the intermediation process and consequently have affected the relationship between money and economic activity.

TYPES OF MUTUAL FUNDS

A mutual fund is a type of investment company. An investment company sells shares or certificates that represent an interest in a pool of financial assets; a mutual fund (technically an open-end company) is an investment company that continuously issues and redeems its shares. The price of such shares, apart from any brokerage commissions, equals the

net asset value of the fund, determined by dividing the market value of the fund's assets, less any liabilities, by the number of outstanding shares. The net asset value is calculated daily as of the close of U.S. securities markets. Open-end funds must redeem their shares on demand at a value equaling the next calculated net asset value and mail proceeds within seven days.

Another type of investment company, the closed-end fund, does not redeem its shares but typically offers a fixed number of nonredeemable shares that are bought and sold on a stock exchange.[1] A third type of investment company is the unit investment trust. Unlike other funds, unit investment trusts hold a relatively fixed portfolio of securities that is not actively managed.

The greater liquidity of open-end funds has helped make them by far the most popular form of investment company. By mid-1993, open-end funds—the focus of this article—held assets of about $1.8 trillion (table 1), as compared with only $90 billion of assets in closed-end funds.

For the most part, the portfolio of a mutual fund consists of marketable securities, both domestic and foreign, such as corporate stocks and bonds, government bonds, municipal bonds, and money market instruments. An individual mutual fund, however, invests in a specific subset of securities defined by its stated investment objective. For example, a money market mutual fund invests in a diversified pool of short-term money market instruments, such as commercial paper, certificates of deposit, and U.S. Treasury bills. Long-term mutual funds are those that invest primarily in stock and bond securities. Because they use certain share valuation techniques based upon historical costs, money funds are allowed to report a constant $1 share value.[2] Stock and bond mutual funds, on the other hand, must report their share values at market prices; hence, investor accounts in these funds may show a gain or a loss on any given day, apart from any distributions.

THE STRUCTURE AND REGULATION OF MUTUAL FUNDS

A mutual fund typically is organized as a business trust or corporation. The board of directors, elected by the shareholders of the fund, is responsible for overseeing the fund's operations. Among the board's duties is the selection, subject to shareholder approval, of an investment adviser to oversee the day-to-day management of the fund.[3]

Responsibilities of the investment adviser include making appropriate investments in line with the fund's investment policies and objectives and conducting economic and financial research. For these services, the adviser receives a fee based on a percentage of the fund's assets. Within certain limits, the adviser's fee income increases with the

1. Closed-end funds are well-suited for investment in less liquid securities, which may not be appropriate for the requirements of open-end mutual funds. In recent years, closed-end funds have been important purchasers of foreign stocks and bonds and of municipal bonds.

2. The Securities and Exchange Commission has given money funds the authority to use either of two accounting techniques of share valuation: amortized cost and penny rounding methods. Under the amortized cost method, a money fund values its securities at historical cost, with any interest earned accrued daily over the life of the assets. By declaring these accruals as a daily dividend to its shareholders, the money fund is able to maintain a $1 price per share. Under the penny rounding method, a money fund rounds its net asset value per share to the nearest one cent to compute the current price of its shares. Most money funds use the amortized cost method of share valuation.

3. Under the Investment Company Act of 1940, which establishes the legal and regulatory framework for the mutual funds industry, at least 40 percent of a fund's directors must be unaffiliated with the investment adviser, with any registered broker–dealer, or with any other interested person.

1. Net assets of the mutual fund industry, by fund type, end of period, selected years, 1960–93:H1

Billions of dollars

Period	Stock	Bond	Money market[1]	Total
1960	11.9	5.1	n.a.	17.0
1965	25.2	10.0	n.a.	35.2
1970	38.5	9.1	n.a.	47.6
1975	32.4	9.8	3.7	45.9
1980	41.0	17.4	76.4	134.8
1985	116.9	134.8	243.8	495.5
1990	245.8	322.7	498.4	1,066.9
1991	367.6	440.9	539.6	1,348.1
1992	475.4	580.9	543.6	1,599.9
1993:H1	581.6	673.7	549.8	1,805.1

1. Taxable and tax-exempt.

Source. Investment Company Institute.

amount of assets under management, an arrangement that gives the adviser an incentive to perform well and to attract new investors. In some cases, the adviser's compensation also varies with the fund's performance relative to some specified benchmark.

The board also retains an independent custodian to hold the fund's assets in trust (except occasionally in the case of a bank-advised fund) and selects a transfer agent to maintain shareholder ownership records and to process orders for sales and redemptions. Governed by the Investment Company Act of 1940, the custodial arrangement is designed to prevent misuse of the fund's assets by the investment adviser. The services provided by the custodian include settling securities transactions, receiving dividends and interest, and making payments for the fund's expenses. Typically, the custodian's compensation varies with the volume of assets under management.

The board also hires an underwriter to sell fund shares either directly to investors or indirectly through brokers.[4] Depository institutions may also sell shares to their customers. Shares in some funds are sold at a premium over the net asset value. This premium, or "front-end load," covers, where applicable, the underwriter's cost, the broker's commission, and other sales and promotional expenses incurred by the fund.[5]

In direct sales or marketing, the underwriter offers shares to investors through the mail, by telephone, or at fund offices. Direct marketers usually do not charge a load; some no-load and low-load funds, however, use annual fees to finance the distribution of their shares to the public.

The Investment Company Act of 1940 is one of several federal statutes governing mutual funds. One of the primary objectives of the act is the protection of investors against abuses, and it contains specific requirements that the mutual fund be operated in the best interests of the fund's shareholders. For example, the statute places restrictions on changing a mutual fund's investment policies without shareholder approval, provides that the adviser's compensation be approved by shareholders and annually approved by the board of directors, prohibits conflict-of-interest transactions between the fund and its affiliates, limits the mutual fund's use of financial leverage, and requires mutual funds to pay redemption proceeds within seven days except under extraordinary circumstances.

Other aspects of mutual fund operations are governed by three other federal statutes: (1) Pursuant to the Securities Act of 1933, mutual funds must provide investors with accurate information about its investment objective, yield, and operating procedures through a prospectus. (2) The Securities Exchange Act of 1934 requires the registration of brokers and dealers with the Securities and Exchange Commission (SEC) and sets certain requirements for the solicitation of shareholder votes and proxies in connection with shareholder meetings. (3) The Investment Advisers Act of 1940 requires the registration of all mutual fund advisers (other than banks or bank holding companies), prohibits fraudulent practices, and gives the SEC enforcement powers.

To determine if the regulatory requirements are met, the SEC reviews disclosure statements and conducts on-site examinations. The SEC reviews fund disclosures about operating plans, management structure, and financial condition. On-site examinations typically probe the funds' valuation techniques, investment activities, management functions, and sales and liquidations of shares.

THE ROLE OF MUTUAL FUNDS IN THE FINANCIAL SYSTEM

Like other financial intermediaries, mutual funds channel savings to different forms of investments. To the saver, mutual funds offer several advantages over the closest, nonintermediary alternative—the direct purchase of stocks and bonds. First, by pooling the savings of many investors, mutual funds can afford to employ professional asset managers and analysts with investment expertise exceeding that of the typical small investor. Second, mutual funds allow small savers to invest in a diversified

4. About 59 percent of all sales of stock and bond fund shares in 1992 were brokered.

5. Back-end loads, in contrast, are charges paid by investors only on redemptions that occur within a specified period after purchase, expressed typically as a percentage of redemption proceeds. Such loads, which usually decline over time, are used to recoup advances to brokers and to discourage trading by investors.

portfolio, thus reducing their exposure to certain types of risk. Typically, the higher transactions costs and minimum purchase sizes encountered in direct investment make diversification difficult for the small investor. Finally, mutual funds offer investors a greater degree of liquidity than would be available through direct investments in the capital markets. For example, mutual funds offer a variety of convenient means for purchasing and redeeming shares, such as making fund investments and portfolio adjustments over the phone and (for money market funds and some bond funds) making redemptions by writing checks.

Mutual funds are distinct from other intermediaries, especially depository institutions, in the way they channel savings. In raising funds, mutual funds issue shares that represent an ownership interest. Shareowners assume all the market risk and credit risk of the fund's assets and share proportionally in all the gains and losses of the fund. Consequently, the return on the shareholder's investment fluctuates with general market conditions and the investment performance of the fund. Banks and thrift institutions, in contrast, primarily issue deposit liabilities with a fixed rate of interest. Most depositors are fully protected by deposit insurance and are not subject to any credit risk.

In supplying funds, mutual funds primarily specialize in marketable securities of firms that have access to the capital markets. Funds must confine their investments to marketable securities in order to meet investor redemptions in a timely manner.[6] Although depository institutions purchase marketable securities, their special role is in providing funds to borrowers who, because of their small size or the complexity or monitoring requirements of the debt contract, may lack access to the public securities markets.

Mutual funds actively compete with banks and thrift institutions for the balances of households and in supplying funds to borrowers. Such competition is limited, however, to those households that are willing to take on additional risk for higher expected returns and to those borrowers capable of financing their needs directly through the securities markets.

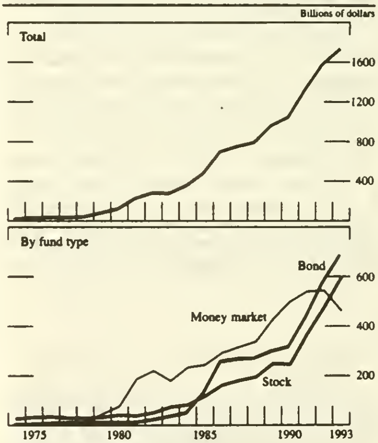
6. SEC guidelines permit a mutual fund to hold up to 15 percent of its net assets in illiquid securities.

THE DEVELOPMENT OF MUTUAL FUNDS

Offered in the mid-1920s, closed-end funds gained acceptance ahead of open-end mutual funds: in 1929 they accounted for 95 percent of industry assets. Open-end mutual funds, however, soon overshadowed them, and between 1940 and 1970 their assets grew more than a hundredfold, to about $48 billion. Throughout this period, they almost exclusively invested in equity, although bond funds also emerged and grew.

In the early 1970s, when volatile stock market conditions along with persistent inflation reduced the attractiveness of bond and equity funds, the industry created money market mutual funds. These funds met the desire of investors to benefit from money market rates, which were then above the level that federal regulation allowed depository institutions to offer on retail accounts, and the success of these funds spurred the development of other funds investing in fixed-income securities: Municipal bond funds were introduced in the mid-1970s, and mortgage-backed and government bond funds were started in the mid-1980s.

1. Net assets of the mutual fund industry, 1974–93



SOURCE. Investment Company Institute.

Mutual funds have continued to play an active role in equity markets, with holdings of equity funds growing from about $40 billion in 1970 to about $580 billion in the first half of 1993. Bond and money funds grew faster over this period, however (chart 1). As a result, the assets of stock funds declined from about 80 percent of industry assets to 34 percent between year-end 1970 and mid-1993, by which time bond funds accounted for about 40 percent of industry assets and money funds about 26 percent (chart 2).

Money Market Mutual Funds

Money market mutual funds grew rapidly in the late 1970s and early 1980s, when interest rates on money market instruments exceeded regulatory ceilings that applied to depository institutions.[7] Flows from depositories to money funds supported expansion of the commercial paper market, an important alternative to bank loans for businesses. The growth of money funds was interrupted temporarily in 1982, when banks and thrift institutions were permitted to offer money market deposit accounts, which were not subject to interest rate ceilings. Money funds resumed their growth in 1983, partly because they remained important to investors in their broader investment strategies. For example, brokerage houses include them as part of cash management accounts. In addition, mutual fund families offer money funds along with stock and bond funds as part of a menu of products that allows investors to switch between short- and long-term funds.

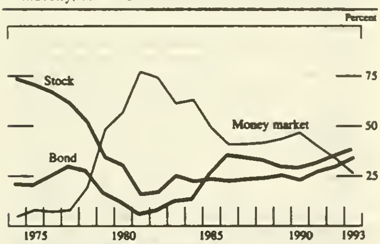
Stock and Bond Funds

In the 1980s, the growth of assets in stock and bond funds was driven by heavy purchases of fund shares, rising stock prices, and lower interest rates (rising bond prices). During this period, investment companies expanded the number and variety of long-term funds they offered. The development of new financial instruments, such as securities backed by mortgages or other assets, and the increased ease of investing overseas spurred the diversification of fund types. Funds investing in specific industries also became popular. The number of long-term funds increased from about 450 at the end of 1979 to about 3,300 by mid-1993.

Inflows to bond funds surged dramatically during the 1985–86 period (chart 3), with the majority of new money going to municipal, mortgage-backed, and government bond funds. Investors withdrew from bond funds in early 1987, when bond prices fell because of an upward move in

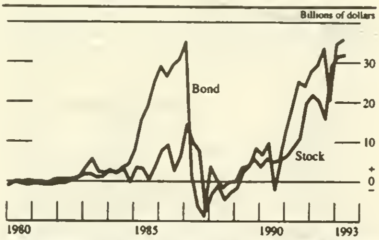
7. For a detailed history, see Timothy Q. Cook and J. G. Duffield, "Money Market Mutual Funds and Other Short-Term Investment Pools," in Timothy Q. Cook and R. K. LaRoche, eds., *Instruments of the Money Market*, 7th ed. (Federal Reserve Bank of Richmond, 1993), pp. 156–72.

2. Share of fund types in total net assets of the mutual fund industry, 1974–93



SOURCE. Investment Company Institute.

3. Net sales of stock and bond mutual funds, 1980–93



1. Net sales are gross sales including reinvested dividends minus gross redemptions.

SOURCE. Investment Company Institute.

interest rates; as deposit rates fell in relation to bond yields in late 1990, investors began moving aggressively into bond funds again. Stock mutual funds grew during the bull market of the mid-1980s and then shrank in the aftermath of the stock market crash in October 1987. In 1989, with stock funds posting strong investment results, inflows resumed.

Retirement Assets

Some of the growth of mutual funds in the 1980s is attributable to their use as investment vehicles for retirement assets (chart 4). In 1982, U.S. tax laws created incentives for investors to open individual retirement accounts (IRAs) and Keogh accounts, which boosted investments in instruments, including mutual funds, that could be structured in the form of such accounts. The upward trend in the asset size of these retirement-oriented mutual fund accounts was interrupted in 1986, after the Congress enacted the Tax Reform Act of 1986, which reduced the number of households eligible to use IRA and Keogh accounts to defer taxes on current income.

In recent years, the share of mutual fund assets held by institutional retirement plans has increased. In addition, investments in IRA and Keogh mutual fund accounts have once again picked up with their use for lump sum distributions and rollovers from employee pension accounts that are liquidated because of a job change or plan termination.

Sales Loads and Fees

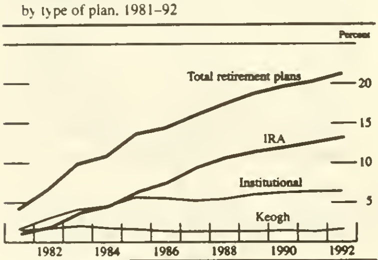
The growth and development of the industry has been associated with a decline in sales loads.[8] Among the mutual funds charging a front-end load, the average load fell from 8.5 percent in 1970 to about 4.5 percent in 1992.[9] Over the same period, the market share of no-load funds increased from 6 percent to about 31 percent of industry assets.

As sales loads have declined, expenses charged to shareholders, as a proportion of assets (the expense ratio), has increased substantially, except in the case of tax-exempt bond funds (table 2). The rise in expense ratios has occurred, however, at the same time that industry assets have been increasing, and insofar as many fund expenses are fixed costs, the growth in industry assets would reduce these ratios. Moreover, mutual funds operate in a

8. In the 1970 amendments to the Investment Company Act of 1940, the Congress authorized the National Association of Securities Dealers (NASD) to prescribe sales loads, subject to SEC oversight, and in 1975 the NASD adopted an 8.5 percent maximum on front-end sales loads.

9. Back-end loads or contingent deferred sales loads (CDSL) are sometimes used in junction with 12b-1 fees as an alternative to front-end sales loads (12b-1 fees are those that can be assessed against fund assets to recover distribution expenses of the fund). For example, instead of charging a 6 percent front-end load, a mutual fund could recoup the same amount through a combination of an annual 1 percent 12b-1 fee and a CDSL of 6 percent that declines 1 percentage point per year until reaching zero after the sixth year.

4. Retirement assets as a share of total mutual fund assets, by type of plan, 1981–92



Source. Investment Company Institute.

2. Ratio of mutual fund expenses to fund assets, and 12b-1 component, by selected fund types, 1982 and 1992

Percent

Fund type	Expense ratio[1]		12b-1 fee ratio[2]	
	1982	1992	1982	1992
Equity	1.08	1.49	.08	.42
International and global	1.29	1.83	.06	.41
Bond	.89	.90	.20	.36
Taxable	.94	1.03	.26	.39
Tax-exempt	.81	.74	.13	.31

1. The sum of all expenses and fees, excluding loads (sales commissions), divided by industry assets.

2. For funds imposing such fees, the ratio of 12b-1 fees to assets. See text for definition of 12b-1 fees.

Source. Lipper Analytical Services.

competitive market, which impedes them from charging fees that exceed competitive levels.[10]

Three factors may have contributed to the rise in the industry expense ratio. Before 1980, a mutual fund's investment adviser and underwriter typically incurred the costs of distributing the fund's shares. In 1980, the SEC adopted rule 12b-1, allowing mutual funds to use their assets to pay for sales commissions, sales literature, advertising, and other distribution expenses. Most no-load and low-load funds have adopted 12b-1 fees to finance their distribution expenses, and the fees have grown as a proportion of assets for funds imposing such fees (table 2).[11] Second, the number of small and international funds, which are more costly to operate, has grown. Third, mutual funds have expanded shareholder services that require costly computer, telephone, and shareholder accounting systems. These expenditures may have offset some of the gains achieved with economies of scale resulting from an increase in industry assets.

RECENT GROWTH OF THE INDUSTRY

Net sales of long-term mutual funds were a record $202 billion in 1992, up from $130 billion in 1991 and easily outpacing the previous record of $144 billion set in 1986 (chart 5).[12] During the first half of 1993, net sales amounted to $135 billion and at that rate will set another record.

10. According to the antitrust criteria of the Department of Justice, an industry with a Herfindahl index of less than 1,000 is considered unconcentrated. For the mutual fund industry as a whole, the Herfindahl index ranged from 500 in 1984 to 380 in 1992.

The Herfindahl index is calculated as the sum of the squares of market shares of all fund complexes in the market. The larger the index, which can range from zero to 10,000, the more concentrated the market.

11. In a rule that became effective in July 1993, the NASD limits the amount of 12b-1 fees that may be charged. The intent of the rule is to ensure that investors will not pay more than 7.25 percent of the purchase price of a mutual fund share when 12b-1 fees, front-end loads, and back-end loads are combined. Also, under the new rule, no fund that charges 12b-1 fees in excess of 0.25 percent can describe itself as a no-load fund.

12. Net sales are gross sales plus reinvested dividends minus gross redemptions. Net sales of bond funds in 1992 were $115 billion, just under the record of $119 billion set in 1986. Net sales of stock funds were $87 billion in 1992, breaking the previous record of $46 billion set in 1991.

One reason for the surge in net sales has been the drop in deposit rates to low levels by historical standards and the accompanying steepening of the yield curve. Although both short-term and long-term rates have fallen since 1989, the decline in short-term rates has been more pronounced. The rate on the six-month Treasury bill fell from 8.8 percent in the spring of 1989 to 3.2 percent in the summer of 1993, and the yield on the thirty-year Treasury bond fell from 8.7 percent to 6.3 percent over the same period. Thus, the returns on long-term assets, such as stock and bond funds, became increasingly attractive relative to rates on deposits at banks and thrift institutions, which follow short-term market rates. In addition, the heavy inflows in recent years may have been aided by the reduced need of depositories to compete aggressively for funds. For example, weak loan demand may have reduced the need of banks to offer competitive rates on deposits. Moreover, competition for funds may have been further reduced by the resolution of failed thrifts, which typically had paid a premium to attract funds.[13] As a result, deposit rates may have been lower than the given decline in market interest rates would have otherwise produced.

The strong net sales of mutual funds may also reflect the high yields that some mutual funds have

13. As the Resolution Trust Corporation closed failed thrifts, it typically paid depositors directly and closed their accounts or sold the deposits to thrift institutions or banks that reset their rates, which in effect pushed average deposit rates down.

5. Net sales of long-term mutual funds, 1982–93

1. Long-term funds exclude money market funds. Sales reported for 1992–93 are quarterly at an annual rate.

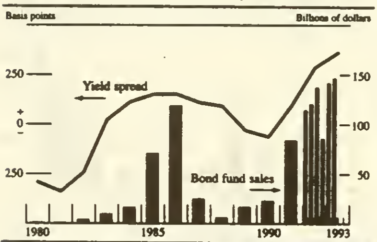
SOURCE. Investment Company Institute.

been able to advertise. One way that a mutual fund differentiates itself and attempts to attract potential investors is to publicize its superior investing skills based upon past performance.[14] Advertisements will often highlight holding-period returns, calculated according to SEC guidelines, relative to some benchmark, such as returns on the issues in the S&P 500 index of stock prices or against other funds with similar investment objectives. Although such advertisements include disclaimers that past performance is no guide to future performance, they may still be effective in convincing investors that the fund has superior investment skills and is likely to enjoy superior future returns. Funds that have strong recent performance tend to have strong inflows, even though most research has failed to show that money managers can persistently produce superior returns.[15] Thus, some of the inflows to mutual funds may reflect the actions of investors who base their expectations of a fund's future returns on the fund's past performance.

14. See Erik R. Sirri and Peter Tufano, "Buying and Selling Mutual Funds: Flows, Performance, Fees, and Services," Harvard Business School Working Paper 93-017 (1992). They show that the demand for mutual funds is weakly related to fees charged and strongly related to services provided and past performance.

15. See W. Sharpe, "Mutual Fund Performance," *Journal of Business*, vol. 39 (January 1966), pp. 119–38; M.C. Jensen, "The Performance of Mutual Funds in the Period 1945–1964," *Journal of Finance*, vol. 23 (May 1968), pp. 389–416; B. Lehmann and D. Modest, "Mutual fund Performance Evaluation: A Comparison of Benchmarks and Benchmark Comparisons," *Journal of Finance*, vol. 42 (June 1987), pp. 233–56; M. Grinblatt and S. Titman, "Mutual Fund Performance: An Analysis of Quarterly Portfolio Holdings," *Journal of Business*, vol. 62 (July 1989), pp. 393–416.

6. Net sales of bond funds and yield spread, 1980–93[1]



1. Yield spread is rate on thirty-year Treasury bond less six-month certificate of deposit. Fund sales reported for 1992–93 are quarterly at an annual rate.
SOURCE. Investment Company Institute.

The surge in purchases of shares in long-term funds is not unprecedented. In 1985 and 1986, investors shifted into bond funds when interest rates fell and the yield curve steepened. In fact, bond funds posted record net sales of $119 billion in 1986, slightly above the $115 billion of net sales in 1992 (chart 6). Inflows came to a halt in April 1987, when interest rates backed up sharply. Also during this period, the demand for bond funds for retirement purposes may have fallen when the Congress placed eligibility limitations on IRA contributions.

HOUSEHOLD OWNERSHIP OF MUTUAL FUNDS

The strong inflows to mutual funds reflect their popularity among households. According to preliminary data from the Federal Reserve Board's Survey of Consumer Finances, households shifted assets from deposits to mutual funds in the 1989–92 period; they held about 13 percent of their financial assets in long-term mutual funds at the end of 1992, up from about 10 percent in 1989, while their holdings of deposits and money funds fell from about 37 percent to 31 percent (table 3). Direct holdings of stocks, bonds, and "other" financial assets (not shown) also slightly increased during this period.[16]

The dispersal of ownership of long-term mutual funds also increased, from about 12 percent of households in 1989 to 15½ percent in 1992. The increase in new ownership was most heavily concentrated among households in which the head was between 55 and 64 years of age. These households apparently shifted assets away from bank deposits and money funds into long-term mutual funds. Their holdings of bank deposits and money fund shares fell from about 40 percent of their financial assets in 1989 to about 22 percent in 1992, while the share of long-term mutual funds in their portfolios rose from about 11 percent to 17 percent over the same period. Somewhat in contrast, the households in the 35–44 age group maintained the share of their financial assets in bank deposits and

16. "Other" financial assets include trusts, annuities, managed investment accounts, call accounts, deposits at uninsured institutions, and the cash value of life insurance.

money fund shares, at about 33 percent, over the 1989–92 period; the share of long-term funds in their portfolios did grow, however, from about 9½ percent to about 12½ percent, while the share of other financial assets declined.

MUTUAL FUNDS AS FINANCIAL INTERMEDIARIES

With their rapid growth, mutual funds have become increasingly important suppliers of debt and equity funds. Indeed, corporations with access to the reduced interest rates and elevated share prices of the capital markets have benefited from the surge in mutual fund assets: In recent years, mutual funds as a group have been the largest net purchaser of equities and a major purchaser of corporate bonds (table 4). Companies have repaid shorter-term debt—especially bank loans—and lowered the costs of long-term debt, while reducing overall balance sheet leverage. Such financial restructuring has been a particularly urgent priority for many of the firms that issued high-yield ("junk") bonds in the 1980s.

Mutual funds have been one of the major suppliers of credit in the high-yield bond market, as certain other institutional investors have pulled back from riskier investments. Recent legislation inhibits thrift institutions from investing in below-investment-grade corporate debt. And the public's concern about the financial health of life insurance companies has led most insurers to curtail their purchases of high-yield bonds and concentrate in high-grade securities. Consequently, flows to high-yield bond funds have played a more important role in the high-yield market than in the past, tending to boost bond prices (narrow yield spreads). Industry sources estimate that mutual funds, which purchased roughly 75 percent of new issuance of high-yield bonds in 1992, now hold about one-half of the stock of such bonds, up from about one-third in the 1980s.

Mutual funds also have increased their presence in the market for tax-exempt securities; they are now the largest net purchaser in that market (table 4) and are offsetting the reduced net purchases by households and the runoff at commercial banks. Banks have been net sellers of tax-exempt securities since passage of the Tax Reform Act of 1986, which significantly reduced the tax advantages for banks owning them. Households in the past several years have relied more heavily on mutual funds for their investments in municipal securities.

BANK-RELATED MUTUAL FUNDS

In response to the outflow of deposits, banks are increasingly participating in the mutual fund busi-

3. Proportion of households with selected characteristics that own long-term mutual funds and their allocation of financial assets in long- and short-term fund accounts, 1989 and 1992[1]

Percent

Household characteristic	Proportion of total financial assets				Proportion owning long-term mutual funds	
	Long-term mutual funds		Short-term mutual funds and bank deposits			
	1989	1992	1989	1992	1989	1992
All households	**9.8**	**13.2**	**36.7**	**30.7**	**11.8**	**15.5**
Age of head (years)						
Less than 35	3.6	5.2	37.5	41.3	6.1	8.4
35–44	9.6	12.4	33.5	33.6	14.3	18.7
45–54	10.8	14.0	33.0	23.0	14.6	18.0
55–64	10.9	17.2	41.0	22.1	14.9	22.2
65 or more	9.7	11.9	36.8	36.0	12.3	14.6
Annual income (dollars)						
Less than 30,000	4.1	7.7	60.5	51.4	4.9	5.7
30,000–49,999	8.6	17.0	42.9	35.5	12.5	19.9
50,000–99,999	11.0	13.1	36.9	30.2	26.2	28.4
100,000–199,999	12.2	14.2	33.2	23.0	42.6	41.8
200,000 or more	11.8	14.4	19.2	18.7	51.7	55.5

1. Preliminary data. In this table, long-term funds exclude all money market mutual funds except those in retirement accounts.

SOURCE. Federal Reserve Board, Survey of Consumer Finances.

Distribution of net purchases of equities, corporate bonds, and tax-exempt securities, by type of investor, selected years, 1980–93.H1

Billions of dollars

Type of investor	1980	1982	1984	1986	1988	1990	1991	1992	1993 H1[1]	MEMO: Level, 1993.H1
					Equities					
Mutual funds[2]	−1.8	3.5	5.9	20.2	−16.0	14.4	44.6	67.2	118.6	562.7
Closed-end funds	−1.2	−.7	−.5	3.0	.6	.7	.3	−1.0	−1.2	19.9
Households[3]	−11.5	−31.8	−70.1	−135.2	−101.0	−27.2	−22.8	−15.9	−83.0	3,055.3
Depository institutions	−.6	−.5	−.2	.9	.5	−3.9	1.8	.4	.3	16.6
Insurance companies	3.5	5.1	−4.1	−2.4	.2	−12.6	−5.6	11.6	21.9	251.1
Pension funds	21.8	28.0	2.5	26.7	13.8	2.3	29.0	22.4	17.6	1,503.9
Foreign	4.2	3.7	−3.4	17.9	−2.9	−16.0	10.4	−5.8	8.2	315.1
Broker–dealers	.1	.9	−1.0	1.4	.2	−3.3	2.4	−.6	8.0	19.2
Total	**14.5**	**8.2**	**−70.9**	**−67.6**	**−104.7**	**−45.7**	**60.1**	**78.2**	**90.4**	**5,743.8**
					Bonds					
Mutual funds[2]	1.3	.2	3.6	26.8	14.2	13.6	12.8	28.4	66.7	162.2
Closed-end funds	.0	.4	−.4	1.4	9.4	−1.7	−1.9	1.9	.9	15.1
Households[3]	−13.8	−2.2	−10.6	35.9	−29.9	18.3	26.2	−.5	−67.6	119.4
Depository institutions	7.1	6.1	17.0	30.5	23.9	−14.7	4.7	6.9	18.6	185.1
Insurance companies	8.8	15.7	27.9	54.9	79.3	65.7	36.2	59.6	85.7	798.1
Pension funds	23.3	13.7	28.1	30.4	36.5	26.6	43.5	18.5	31.1	460.0
Foreign	9.2	15.7	15.6	39.1	15.9	5.3	16.2	18.5	24.2	255.5
Broker–dealers	.4	2.5	5.7	.3	9.8	−4.0	12.0	10.0	20.3	61.0
Total	**36.3**	**52.1**	**86.8**	**219.4**	**159.0**	**109.2**	**149.6**	**143.3**	**179.9**	**2,056.4**
					Tax-exempt securities					
Mutual funds[4]	2.0	10.9	12.6	59.3	12.3	29.8	34.2	40.7	53.9	295.8
Closed-end funds	.0	.0	.0	1.1	3.8	1.8	14.1	11.8	10.4	45.1
Households[3]	.8	31.2	31.7	−2.8	50.4	34.1	44.1	11.6	18.1	610.8
Depository institutions	12.7	4.3	12.2	−28.7	−22.5	−16.0	−14.8	−6.0	−1.4	98.9
Insurance companies	8.0	4.9	−3.2	15.6	7.8	5.5	−12.2	8.7	5.8	148.6
Other[5]	.5	1.8	5.4	1.3	2.0	2.2	4.2	−1.1	−23.3	24.8
Total	**23.9**	**53.1**	**58.7**	**45.7**	**53.7**	**57.4**	**69.6**	**65.7**	**61.4**	**1,224.0**

1. Annual rate.
2. Excludes money market mututal funds.
3. Includes nonprofit organizations and personal trusts administered by banks and nondeposit noninsured trust companies.
4. Includes money market mutual funds.
5. Pension funds, broker–dealers, nonfarm nonfinancial corporate business, and state and local government general funds.

SOURCE. Federal Reserve Board, flow of funds accounts.

ness through the advising of mutual funds and through the brokering of mutual fund shares. Banks and bank holding companies are prohibited from underwriting, distributing, or sponsoring mutual funds, according to interpretations of the Glass–Steagall Act of 1933 by the courts and federal regulatory agencies.[17]

17. *Investment Company Institute et al. v. Camp, Comptroller of the Currency, et al.*, 401 U.S. 617 (1971).

Nevertheless, several rule changes have made it possible for banks to increase their participation in the industry.[18] In 1972, the Federal Reserve Board authorized bank holding companies to act as mutual fund investment advisers, transfer agents, and custodians.[19] In an accompanying interpretation, the Board placed several restrictions on the activities of bank holding companies that advise mutual funds. For example, neither a bank holding company nor its bank or nonbank affiliates could promote any mutual fund, or provide investment advice to any customer investing in any mutual fund, for which it acted as an investment adviser. In addition, the Board cautioned bank holding companies from advising a mutual fund, unless the fund was located off the bank's premises. In 1992, the Board relaxed some of these restrictions. Provided that a number of disclosures are made to customers regarding the bank holding company's relationship to the mutual fund and the status of mutual funds as an uninsured investment product, the Board allowed a bank holding company or its subsidiary to provide investment advice and other brokerage services to customers investing in any bank-advised fund. In addition, the Board eliminated the location restriction.

A banking organization can participate in the mutual funds industry in several ways. One is through a proprietary mutual fund (a fund advised by the bank), with the shares brokered by the bank primarily to its customers. An unaffiliated third party, however, organizes the fund and an unaffiliated distributor underwrites the shares. In addition, a bank can sell shares of nonproprietary funds, for which it acts only as broker. Involvement in the brokerage of these funds can range from renting lobby space to an unaffiliated broker to selling fund shares through a brokerage firm affiliated with the bank. Although the bank is providing only brokerage services, it does earn fee income from sales commissions and enters the retail mutual funds market at a low initial expense.

Net assets of bank proprietary mutual funds, including both long-term and money market funds, are estimated to have increased from $31 billion at the end of 1987 to $162 billion at the end of the first quarter of 1993 (table 5). Money market funds account for the majority of bank-related mutual fund assets, but bank-related long-term funds have grown rapidly in the past several years and are about evenly split between stock and bond funds. Between 1987 and early 1993, banks increased their market share of total industry assets from 4 percent to nearly 10 percent (table 5). However, they have had much greater penetration in the money fund sector than in the stock and bond sectors. At the end of the first quarter of 1993, bank money funds accounted for about 20 percent of total money fund assets, whereas bank long-term mutual funds were only about 4 percent of total stock and bond fund assets.

IMPLICATIONS FOR THE INTERMEDIATION PROCESS

By providing savers with investment options and by participating in the market for securities, mutual funds compete with other financial intermediaries. Although some intermediaries may have been

18. See Melanie L. Fein, *Securities Activities of Banks* (Prentice-Hall, 1992), for a detailed account of the regulatory changes.

19. The Board's authorization was upheld by the Supreme Court against a challenge by the Investment Company Institute, the trade group for the mutual funds industry (*Board of Governors of the Federal Reserve System v. Investment Company Institute*, 450 U.S. 46 (1981).

5. Net assets of proprietary bank funds, end of period, selected years, 1987–93:Q1
Billions of dollars

Fund type	1987	1989	1991	1992	1993:Q1
Money market	28	45	83	102	113
Long-term	3	7	20	42	49
Total	31	52	103	144	162
MEMO					
Percentage of all mutual fund assets	4.0	5.3	7.6	9.0	9.5

SOURCE. Calculated from data provided by Lipper Analytical Services.

adversely affected by the rise of such competition, mutual funds have tended to make the financial system more efficient by reducing the transactions costs to households seeking saving alternatives and to borrowers issuing securities.

Clearly, the growth of the mutual funds industry has challenged the traditional role of banks. Mutual funds pose a competitive threat by offering saving instruments that have become more attractive alternative to bank deposits, given their liquidity and other characteristics. Recent experience also suggests that households are quite sensitive to changes in returns on bank deposits relative to those on mutual fund shares. Mutual funds are aggressively attempting to exploit the greater household awareness by offering new types of funds, additional shareholder services, and retirement products.

Mutual funds also challenge banks to the extent that bank borrowers can directly tap the capital markets. As mutual funds grow, they make securities markets accessible to many borrowers that were previously confined to bank loans—medium-sized businesses and individuals, who gain indirect access to the public market through asset securitization.

As investors, mutual funds have played an important role in the development of markets for securitized financial assets. Securitization began with mortgages in the 1970s and has since spread to other types of financial assets, such as automobile loans and credit card receivables.[20] Banks and other nonbank institutions have increasingly securitized such assets and sold them to various investors, including mutual funds. Securitization allows banks and thrift institutions to continue to originate loans by having mutual funds and other investors fund such loans.[21] This form of intermediation thus complements lending by depository institutions but also produces greater competition in the provision of financial services.

Asset quality problems, higher regulatory capital requirements, and cautious lending also have added to the downward trend in the amount of intermediation through banks in recent years. Accompanying this diminished role for depository institutions in the credit markets has been the slow growth in broad measures of the money supply. Such slowness is reflected in the velocity of M2, which is the ratio of gross domestic product to M2. In the past, decreases in short-term interest rates have lowered the opportunity cost of holding deposits, as deposit rates typically lagged the decline in market yields, thus causing the level of M2 to rise relative to output and its velocity to fall. In the past three years, however, the velocity of M2 has risen in the face of the general decline in market interest rates.[22]

OUTLOOK

The mutual fund industry will remain an important investment option for household savings and an important funding source for corporations and state and local governments that can directly tap the capital markets. Growth of the industry may subside as the yield curve flattens and inflows into long-term stock and bond funds slows. However, the introduction of new types of funds and services, the potential for the growth of funds marketed through banks, and the demographic forces that favor retirement products will tend to support industry growth. □

20. The securitization of loans to small and less creditworthy firms has been rather limited. Thus, banks cannot easily originate and sell such loans into the secondary markets and have accordingly retained the business of these borrowers, who typically cannot directly tap the capital markets to obtain financing. Recent regulatory changes have made it easier for banks and other financial intermediaries to issue securities backed by small business loans in the public markets, but banks still need to evaluate and monitor the creditworthiness of such borrowers

21. By securitizing, banks and thrift institutions save on capital costs, earn fee income from servicing the loans, and earn interest income from the spread between the borrowers' rate and the rate paid to the investors.

22. See Bryon Higgins, "Policy Implications of Recent M2 Behavior," Federal Reserve Bank of Kansas City, *Economic Review*, Third Quarter 1992, pp. 21–36; and John V. Duca, "The Case of the Missing M2," Federal Reserve Bank of Dallas, *Economic Review*, Second Quarter 1992, pp. 1–24.

For Release Upon Delivery
10:00 a.m., March 8, 1994

TESTIMONY OF

EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION, AND DEPOSIT INSURANCE

of the

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

of the

U. S. HOUSE OF REPRESENTATIVES

March 8, 1994

I. Introduction

Mr. Chairman and members of the Subcommittee, I am pleased to be here to testify on the issues related to bank sales of mutual funds. As supervisor of national banks, the Office of the Comptroller of the Currency (OCC) is firmly committed to ensuring that banks fully inform their customers about the uninsured status of the mutual funds or other nondeposit investment products they buy on bank premises. As bank retail sales of mutual funds have grown in recent years, such safeguards have become increasingly important--to protect bank customers, and to protect banks that sell uninsured investment products.

My statement will describe the important steps our agency has taken to help ensure that bank customers are fully informed about the risks associated with nondeposit investment products:

- In July 1993, we published detailed industry guidance on the retail sale of mutual funds and other nondeposit investment products.

- We worked closely with the other Federal regulators of banks and thrifts to develop an interagency policy statement, which the agencies released jointly last month.

- I had a number of meetings with industry leaders to impress upon them the importance of taking steps to avoid customer confusion. Partially as a result of those meetings, the banking trade associations adopted retail investment sales guidelines.

- The OCC developed a program of mutual fund examinations, and issued new examination procedures to ensure that national banks comply with our guidelines.

- I had a number of meetings with Securities and Exchange Commission (SEC) Chairman Arthur Levitt to discuss the issues surrounding bank sales of mutual funds, and we initiated ongoing staff-to-staff contacts to see how we could coordinate our supervisory efforts.

- OCC and SEC staff have initiated a joint research effort, including a comprehensive survey of households, to improve our understanding of the sources of confusion when individuals purchase mutual fund shares and to learn what kinds of disclosures work best in addressing that confusion. Working with the banking industry, the OCC has begun an effort to learn directly from bank customers about their experiences in purchasing mutual funds from banks.

- We published a brochure entitled *Deposits and Investments: There's A Critical Difference* to alert bank customers to the risks in nondeposit products sold by

banks. Nearly one million copies of the brochure have been made available to the public.

We are working steadily toward the important goal of customer protection, through the adoption of the interagency policy statement and the other actions I will now describe. Certainly, however, if we should find in the future that we are falling short of our goal, we will take further action.

II. OCC Initiatives to Ensure that Banks Adequately Disclose Risks of Uninsured Products

The sale of mutual funds by banks affords the public greater convenience and permits banks to compete more effectively for customers, but those benefits will be realized only if mutual fund sales are accompanied by full consumer protections. The presumption that bank customers are protected from loss by the Federal Deposit Insurance Corporation (FDIC) appears to be deeply ingrained in the public perception of bank products.

The OCC has a clear responsibility to ensure that customers of national banks are fully informed about the uninsured status of the mutual funds and other nondeposit investment products that national banks offer. Banks that sell mutual funds need to convey clearly to their customers that mutual fund investments differ from bank deposits: customers risk the loss of both principal and earnings, and federal deposit insurance does not protect against such losses. Since I became Comptroller, the OCC has taken a number of steps to improve our supervision of banks engaged in the retail sale of nondeposit investment products.

Supervision of Bank Mutual Fund Activities

As bank mutual fund sales increased in volume, the OCC and its sister agencies have recognized the need for more comprehensive policy guidance. On July 19, 1993, the OCC issued Banking Circular 274. That circular provided the first comprehensive guidance to national banks on the sale of mutual funds, annuities, and other nondeposit investment products. On February 17, 1994, the OCC, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, and the Office of Thrift Supervision jointly issued the *Interagency Statement on Retail Sales of Nondeposit Investment Products*, which replaced the guidances issued by the individual agencies, including Banking Circular 274.

The new *Interagency Statement* covers all aspects of a bank's nondeposit retail sales operation, including sales by bank employees and sales by employees of third party vendors on bank premises. The guidance stresses that banks should view customers' interests as central to all aspects of their sales programs, and that the federal banking regulators will take appropriate actions to address unsafe and unsound banking practices and violations of law and regulations associated with bank-related sales of mutual funds and other retail nondeposit investment products.

To reduce customer confusion between insured and uninsured products, the *Interagency Statement* contains the following specific guidelines:

- o Disclosure and advertising for mutual fund and other investment products should clearly indicate that the products are not FDIC insured, are not obligations of the bank, are not guaranteed by the bank, and involve risk, including the possible loss of principal. Banks should obtain a signed statement from customers acknowledging that they have been informed as to the nature of these investment products.

- o Bank tellers or other bank employees working in the teller area should not sell uninsured investment products or offer investment advice. Banks should take steps to distinguish between the retail deposit-taking and retail nondeposit sales functions.

- o A bank should not offer investment products with a name identical to that of the bank. Because of the potential for customer confusion, the guidance warns banks about the risk of marketing or offering investment products that have names similar to the bank's name, and provides for heightened scrutiny of programs that use such names.

The interagency guidance also covers the supervision and training of staff who recommend and sell investment products, compensation incentives for staff, and the need to ensure that particular investment products that the bank recommends are suitable for the individual customer.

In August and September 1993, the OCC began testing detailed examination procedures for mutual fund activities of national banks and training examiners in the use of those procedures. On February 24, 1994, drawing on experience gained in using the draft procedures in the field, the OCC issued detailed guidance to examiners on retail sales of nondeposit investment products such as mutual funds.

The guidance sets forth the procedures that examiners are to use when evaluating the adequacy of a bank's policies and procedures. It instructs examiners to determine that:

- o The bank's board of directors and senior management oversee the scope and direction of the bank's mutual fund (and other retail nondeposit investment sales) activities.

- o The bank has implemented appropriate standards for the qualifications, training, compensation of mutual fund sales personnel, and senior management provides the appropriate oversight.

- o The bank's customer disclosures are conspicuous, and both disclosures and advertising are accurate and complete, placing particular emphasis on the riskiness and uninsured status of mutual fund accounts.

- o The bank has developed appropriate systems to ensure that sales personnel make suitable recommendations to individual bank customers, and that management is discharging its responsibilities under these systems.

- o The bank's policies governing the permissible uses of bank customer information reduce possible confusion among depositors who are being solicited to purchase mutual funds and other nondeposit investment products.

- o The bank is in compliance with state and federal restrictions on the sale of mutual fund transactions involving the bank's fiduciary accounts.

- o The bank is exercising appropriate oversight of third party vendors.

Mutual Fund Examinations

In the past year, OCC examiners visited over 300 national banks, including all of the multinational banks, that are active in mutual fund sales to review the kinds of disclosures they are using and how well they are working. During our review, our examiners found many instances of incomplete or insufficiently conspicuous disclosures. In such circumstances, our policy has been to discuss our findings with bank management and provide additional clarification of our expectations where needed. We have required many banks to revise, supplement, or remove from circulation any inappropriate disclosures. We have also required banks to develop systems to help ensure compliance in the future. Generally, we have found these institutions to be cooperative in implementing corrective measures. They have adopted central review processes, scripts for use by bank and sales personnel, and testing programs to ensure that their systems are effective. Some banks have unwound customer transactions after we pointed out deficiencies in existing systems.

Going forward, the OCC will examine all national banks that sell mutual funds or annuities as part of the OCC's regularly scheduled examinations. The frequency of examination varies from every 12 to every 18 months, depending on the bank's asset size, its overall condition, and the occurence of a change in control of a bank. We will examine most banks once every 12 months.

In these examinations, our examiners will use the new procedures that I described above. They will review the bank's business plan and the policies and procedures governing its mutual fund operations, its compliance with OCC guidelines, its response to any criticism that the OCC made in previous examinations, and its compliance with all other applicable laws, rules, regulations, and regulatory conditions imposed by bank regulators. They will review selected

individual accounts to ensure that sales representatives are adequately trained and are following appropriate procedures.

We will tailor the examinations to the scope of the bank's mutual fund sales activities. Large banks that operate their own sales programs will initially receive more extensive examinations than community banks that rely exclusively on independent third party vendors to operate their mutual fund sales programs. In both cases, however, examiners will expand the scope of the examination to address issues raised in their initial review.

Nevertheless, it is clear to any newspaper reader that we still have far to go in this area. Many institutions continue to market their mutual fund products in ways that could mislead some consumers. In months ahead, we will be treating such practices with increasing severity.

OCC Examiner Training on Mutual Funds

The OCC is conducting training sessions for its examiners to provide information about the nondeposit investment products banks are selling and OCC policy regarding bank sales of those products. In September, 1993, OCC held a seminar to train 36 examiners and capital markets specialists from each OCC district and our headquarters staff. The seminar addressed issues related to bank sales of mutual funds and annuities, including Banking Circular 274. Parts of the training focused on questions resulting from examiner visits to national banks conducting mutual fund sales. We asked session participants to field test the examination procedures on retail sales of nondeposit investment products that we released on February 17.

This month, the OCC's Capital Markets Group will hold a training session on mutual funds and annuities in Washington, D.C. The session will be attended by senior commissioned examiners and capital markets specialists with experience examining mutual funds and annuity sales activities in banks. It will focus on the *Interagency Statement on Retail Sales of Nondeposit Investment Products* and practical application of the OCC's examination procedures for bank activities in this area. The participants will then return to their districts to conduct similar training sessions.

Joint Supervisory Efforts with the SEC

The OCC and SEC are coordinating their oversight of bank mutual fund sales activities in the following two areas.

Joint Examinations. The OCC has proposed to the SEC that the two agencies conduct joint examinations of banks and operating subsidiaries involved in mutual fund sales activities. On February 22, 1994, OCC and SEC staffs discussed developing general guidelines for handling these examinations, including how to determine the scope of the examinations, allocate work responsibilities, and prepare examination reports.

The OCC has also proposed to the SEC that the two agencies coordinate examination efforts for banks that are subject to oversight by both agencies. We proposed coordinating examinations and sharing information on entities that, although subject to only one agency's oversight, would be relevant to the other agency's supervisory efforts.

Disclosures. OCC staff arranged an interagency meeting with staff of the SEC, the Federal Reserve Board, and the Office of Thrift Supervision to discuss coordinating banking agency disclosures with the SEC's disclosures. We discussed the possibility of developing consistent disclosures for both bank regulatory purposes and for SEC requirements, particularly with regard to the SEC's required disclosures on the cover page of the prospectus. We also discussed the SEC's plans to handle situations where funds are sold in bank-related sales without the required disclosures on the prospectus.

OCC Brochure Alerting Bank Customers to Mutual Fund Risks

In November 1993, the OCC released a brochure entitled *Deposits and Investments: There's A Critical Difference*. The brochure, which was designed to inform bank customers that mutual funds and other nondeposit investment products they buy are not insured by the FDIC, explains the difference between insured deposits and mutual funds, annuities, or other investments. The brochure also describes the role the government plays in regulating deposits and investments, explains investment products, programs, and fees charged by some banks, offers tips for first-time investors, and provides guidance to customers who have a problem or want to find out more about investments.

The OCC mailed the brochure to all national banks last November, accompanied by a letter encouraging bankers to use similar information in their own marketing programs for investment products. Banks and other interested parties, including law firms, investment houses, marketing firms, and trade groups, have reprinted it for their own use. In addition, the American Bankers Association is reproducing the brochure and providing multiple copies to all its members. Nearly one million copies of the brochure have been made available to the public.

Additional Efforts

I personally have taken every opportunity to deliver the message that bank disclosures are critically important. Last year, I discussed the concerns raised by bank mutual fund sales in three speeches, with consumer groups, and in interviews with the news media. Last November, I sent a letter to the chief executive officers of all national banks reiterating the importance of ensuring that customers purchasing mutual funds and other nondeposit investment products through banks are fully informed about their uninsured status.

III. OCC Comments Regarding H.R. 3306

In your letter of invitation, you asked for my views on H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act. The OCC strongly supports the investor protections that H.R. 3306 is designed to provide; however, the Administration has not yet determined whether additional legislation in the area of bank retail sales of nondeposit investment products is necessary at this time. Along with the other federal banking agencies, our agency has already taken significant steps to accomplish the goals underlying H.R. 3306.

The principal safeguards found in H.R. 3306 have been built into the *Interagency Statement on Retail Sales of Nondeposit Investment Products*. These safeguards include standards for customer disclosures, standards for naming nondeposit investment products, requirements that sales taking place on the premises of a depository institution be conducted in a physical location distinct from the area where retail deposits are taken, requirements that sales representatives ascertain the suitability of investment products for customers, and an admonition that tellers and other employees located in deposit-taking areas should not make investment recommendations or accept orders for nondeposit investment products, even if unsolicited. The voluntary guidelines adopted by the depository institution trade associations also incorporate many of the actions that would be required under H.R. 3306.

IV. Conclusion

The OCC shares the Subcommittee's concern that bank customers must be informed about the risks associated with nondeposit investment products. We have worked hard to send national banks one basic message: Banks must avoid any sales practices that have the potential to confuse customers about the uninsured status of, and the nature of the risks associated with, any mutual funds or other nondeposit investment products sold on their premises. We are taking a number of actions to help ensure that banks adopt and enforce appropriate sales practices, and that those practices include full and adequate disclosures regarding the risks associated with any uninsured products. Our examiners are reviewing banks' efforts to comply with these actions. We are determined to reduce the level of customer confusion to the lowest feasible level. Should we find that our actions to date have been inadequate, we will take further steps to address this important problem.

EMBARGOED
until Mar 8, 10 am

Testimony
of
Jonathan L. Fiechter, Acting Director
Office of Thrift Supervision

concerning

Mutual Fund Sales

before the
Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance
of the
Committee on Banking, Finance and Urban Affairs
United States House of Representatives

March 8, 1994

Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington D.C. 20552
202•906•6288

I. INTRODUCTION

Good Morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to provide the Office of Thrift Supervision's (OTS) views on the appropriate regulation of sales by banks and thrifts of mutual funds and other uninsured investment products.

Because of the current low interest rate environment, many depositors in search of higher investment yields have shifted their funds from savings accounts at insured depository institutions to investment products issued by other providers of financial services. Since 1989, there has been no net growth in the total combined deposits of thrifts and banks, while the total assets of mutual funds and money market funds have increased by 92%, from $944 billion to $1.9 trillion, as of the end of the third quarter of 1993. This compares to total bank and thrift deposits of $3.4 trillion.

Not surprisingly, many depository institutions are initiating or stepping up sales of investment products, such as mutual funds and annuities, in an effort to retain customer relationships and to generate fee income, in competition with other financial services providers.

The sale of mutual funds in thrift offices presents risks. We believe, however, that these risks can be effectively managed through a program of sensible regulation. Given the substantial benefits that may accrue to thrifts that sell uninsured products, we support thrifts' continued participation in these activities subject to prudent controls.

II. SALE OF UNINSURED PRODUCTS BY THRIFTS: BENEFITS AND RISKS

Like other insured depository institutions, thrifts can better meet the needs of their customers and enhance their business operations by selling uninsured products. A well-managed program offering various investment products may enable a thrift to retain customers even in a low interest rate environment. It can increase the institution's competitiveness and its appeal to new customers by enabling the thrift to offer "one-stop shopping" for various financial services. It generates fee income. Finally, a thrift that provides brokerage services on its own premises can offer the product at a competitive price -- the thrift incurs no capital costs and no new facilities are necessary.

These benefits carry with them certain risks, however. In particular, as sales activity in the financial products arena increases, the potential for customer confusion also increases.

Consumer surveys conducted over the years have found that many customers have incorrectly believed that money-market mutual funds investing in government securities and offering check-writing were federally insured. The potential for such confusion has increased as depository institutions have begun distributing these products. In fact, recent press accounts and survey results, such as the American Association of Retired Persons', (AARP) and North American Securities Administrators Association survey released earlier this year, have indicated that customers continue to be confused about both the insurance coverage and the investment risks of the various types of mutual funds offered in depository institutions.

Customers purchasing investment products in depository institutions are more likely to view the product offered in the institution as being "safe" or "insured." As a result of inadequate disclosure or misleading marketing, customers unfamiliar with mutual funds, annuities and the like may fail to understand that they are not insured by the Federal Deposit Insurance Corporation (FDIC). Similarities between the features of some mutual funds and certain deposit accounts offered by financial institutions -- such as the ability to earn interest in a money-market mutual fund and to write checks -- probably contribute significantly to customer confusion, regardless of the source of the mutual fund sale.

For instance, a survey released in November, 1993 by the Securities and Exchange Commission's (SEC) Office of Economic Analysis revealed that of 1,000 households surveyed, 36% believed that mutual funds purchased from a stockbroker are federally insured, but 49% believed that money-market mutual funds sold through banks are federally insured. Thus, while a significant minority of the public is generally confused over the risks of mutual funds, that confusion seems to be greater when the product is similar to a traditional bank product and purchased through a depository institution.

Another risk is that a customer will invest in a product without fully understanding the financial risks it presents. The public is shifting an increasing portion of its savings into the more volatile types of mutual funds. The business sections of most daily newspapers and national news magazines carry advertisements showing the high yield that could have been earned over the last year from an investment in various equity mutual and corporate bond funds. These advertised yields are likely to be much higher than the yield on an insured certificate of deposit or a money-market mutual fund.

But the customer's risk of loss from such investments is also substantially higher than from either a certificate of deposit or a money-market mutual fund. Customers may not ask or be advised about whether such an investment is appropriate for their needs. Certain vulnerable segments of the population may be specially targeted during marketing, contributing to the likelihood of confusion. Unfortunately, the risk of confusion may be greater when the customer purchases the mutual fund through a bank or thrift rather than through the mail or from a broker. Because of the association of the fund with the insured institution, customers unfamiliar with the risks of these funds may assume they are less risky because of where they purchased them. This confusion could undermine confidence in the banking system if losses occur.

III. OTS REGULATION OF THE SALE OF UNINSURED PRODUCTS

Thrifts that engage in securities brokerage activities do so indirectly either through service corporations or through lease arrangements with third-party broker-dealers. These service corporations may register as broker-dealers themselves, or they may contract with third-party broker-dealers who actually conduct the sales activities. The service corporation or third-party may sell uninsured products on the premises of the savings association or off-premises.

Entities subject to OTS oversight that engage in the sale of uninsured products are subject to a comprehensive regulatory regime comprising several important components. First, OTS's service corporation regulations apply to sales activities conducted through a service corporation whether or not they are offered on the thrift's premises. Second, OTS rules specifically govern the sale of a thrift's own securities (or those of an affiliate) on a thrift's premises. Third, OTS has joined the other Federal banking agencies in issuing a policy statement that applies to sales activities conducted on a thrift's premises or off-premises if the thrift receives a fee or other benefit from the sale. Finally, unlike the banking industry, the thrift industry is subject to the requirements that govern broker-dealers and investment advisors under the federal securities laws.

A. Service Corporation Rules

Service corporations are subject to the OTS's service corporation regulations that specifically address the sale of non-FDIC insured investment products in thrift offices through service corporations or affiliates.

The first application to engage in discount brokerage activities through a service corporation was approved nearly twelve years ago. Through the experience our agency has gained since then, we have developed standards for the conduct of these activities that are designed to reduce the confusion that can occur when uninsured securities are sold on the premises of an insured institution. The key features of our regulation governing a thrift's sale of uninsured products indirectly through its service corporation are as follows:

- Sales activities must take place in a separate and distinct area. The physical separation and signage must communicate visually that the activities are different from the institution's banking activities.

- The advertising of uninsured products must be distinguishable from that of the association and not indicate or imply that securities are insured or that the insured institution is issuing or selling the securities. The thrift's logo may not be used to advertise uninsured products.

- The association and its service corporation are required to observe corporate separateness.

- Brokers are prohibited from soliciting transactions in specific securities.

- Brokers must certify annually that they have adequate supervisory systems in place to detect and prevent violations of federal securities laws and regulations, including those designed to prevent unsuitable recommendations, churning and fraudulent representations, and that they have discharged their supervisory obligations and are not aware that violations have occurred.

- Tellers are not permitted to be involved in the investment product sales except to refer depositors who want to discuss investments to the brokerage area.

- Tellers and other unregistered persons are subject to SEC no-action positions, which generally prohibit them from describing investment vehicles, such as mutual funds; handling funds or securities; or responding to questions about the securities industry.

OTS requires a notification or application before a savings association may engage in brokerage activities indirectly through its service corporation. Also, pursuant to OTS guidelines, broker-dealers leasing excess office space from a thrift are subject to similar restrictions as a matter of policy.

B. Regulation Governing the Sale of an Institution's Own Securities and Affiliated Mutual Funds

Since 1986 the OTS has had regulations governing the sale of securities issued by a savings association or its affiliates in the offices of an association. In 1992, a new regulation was issued that generally prohibits the on-premises sale of a thrift's own securities or those issued by its affiliates. There are a few exceptions to this prohibition, including the sale of equity securities issued by the savings association or an affiliate in connection with a mutual-to-stock conversion and the sale of mutual funds that are sponsored, advised, distributed or administered by a savings association, its holding company or subsidiary of a holding company.

In such sales, however, the regulation requires several safeguards. These include prohibitions on compensation, common sales areas, and fraudulent or misleading advertising. The regulation also requires that customers sign a prescribed form certifying that the customer has been given a copy of the offering circular and is aware that the security is not a deposit account and not insured by the FDIC.

OTS also issued a thrift bulletin to provide further guidance on what directors and managers should do to ensure that these permitted sales are conducted in a safe and sound manner.

These safeguards are more stringent than those included in the Interagency Statement that I next describe because, in our view, the sale of the association's own securities (or those of its affiliates) on the premises of a savings association carries a greater risk for customer confusion. Accordingly, such sales should be subject to safeguards in addition to those that apply to the sale of securities generally.

C. Interagency Statement

On February 15, 1994, the OTS, along with the other federal banking agencies, issued an Interagency Statement on Retail Sales of Nondeposit Investment Products. The statement was issued to ensure that all depository institutions follow the same standards. The statement addresses issues of customer confusion and safety and soundness on a consistent basis.

The statement applies to the sale of retail nondeposit investment products on the premises of thrifts or banks, regardless of whether the sales activities are conducted by employees of the institution, its service corporation, or any third-party broker-dealer. The statement also covers sales resulting from a customer referral by the institution to a third party when the depository institution receives a benefit for the referral.

The statement sets out the fundamental elements of a sound, well-managed program for the sale of uninsured products. These elements include the following:

- Policies and Procedures - A savings association should adopt a written document addressing the risks associated with the sales program and containing a summary of policies and procedures as well as means of compliance, which should be reviewed periodically.

- Disclosures - To minimize the potential for confusion about the type of investment, its risks, the issuer, and its insurance status, brokers should disclose to their thrift customers that the security is:

  (1) not insured by the FDIC;

  (2) not a deposit or other obligation of, or guaranteed by, the depository institution; and

  (3) subject to investment risks, including possible loss of the principal investment.

  Written disclosures are to be conspicuous, clear and concise. Advertisements should also contain these disclosures and should not suggest or convey an inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance.

  The disclosures are to be presented orally during sales presentations and recommendations, and orally and in writing by the time an investment account is opened. Further, a signed acknowledgment should be obtained from the customer stating that he or she has received and understands the disclosures when the account is opened.

  Making the disclosure and obtaining a customer's signature prior to a transaction alerts the customer to the differences in investment products and reduces the possibility that sales representatives might neglect to make such disclosures. This disclosure must occur prior to a customer's executing a securities transaction in order to be effective.

- Location of Sales - Sales of nondeposit investment products should be conducted in a physical location distinct from the area where retail deposits are taken and that signs and other means should also be used to distinguish the investment sales area.

- Separation of Duties - The statement includes a restriction on sales of investment products at the teller windows.

- Training, Suitability and Qualifications - Sales representatives should be trained to have a thorough knowledge of the products they offer and their regulatory obligations for customer protection. In addition, they should fully disclose the characteristics and issuers of the products that they recommend and sell in a way that they are reasonably sure the customer understands. In this regard, we expect the training will be conducted by experienced personnel for a sufficient period of time and include, among other things, what must be disclosed and what may and may not be said during the sales presentations.

  Investment recommendations should be based on reasonable grounds and result after obtaining customer financial information and goals. In addition, incentive programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

  Only registered representatives may sell investment products or provide investment advice in savings associations. With respect to qualification, the statement recommends that institutions investigate the backgrounds of the registered representatives they hire.

- Referral Fees - Institution employees such as tellers may receive a one-time nominal fee of a fixed dollar amount for customer referrals. However, the referral fee may not depend on whether a sale is made.

- Examinations/Supervision - The statement makes clear that the federal banking agencies will continue to monitor these sales programs carefully. Institutions that fail to develop, implement and comply with appropriate policies and procedures will be subject to criticism and appropriate corrective measures will be taken.

D. Federal Securities Laws

Finally, thrifts, unlike banks, are not exempt from the definitions of "broker" and "dealer" under the federal securities laws. Therefore, every thrift, thrift service corporation or affiliate, or third-party lessee of thrift office space that buys or sells securities for the accounts of depositors and other retail customers is registered with the SEC (and subject to SEC examination and enforcement authority) and is a member of the National Association of Securities Dealers, Inc. (NASD). In addition, unlike banks, thrifts that are investment advisors to

mutual funds are subject to regulation by the SEC under the Investment Advisors Act of 1940. Thrifts engaging in mutual fund sales activities also are subject to the anti-fraud provisions (Section 10b and Rule 10b-5) of the Securities Exchange Act of 1934. Service corporations may register as broker-dealers themselves or contract with brokers and act consistent with an SEC no-action letter permitting such affiliation without requiring the thrift or its service corporation to register as broker-dealers.

Finally, thrift transactions with mutual fund affiliates are subject to the affiliated transactions provisions of Section 23A and B of the Federal Reserve Act and related OTS rules. Thrift broker-dealers' recommendations, sales, advertising and other activities are directly subject to the statutory and regulatory requirements of the SEC and the NASD.

IV. DISCUSSION OF H.R. 3306

We support the overall goals and objectives of H.R. 3306, the "Depository Institution Retail Investment Sales and Disclosure Act," to prevent customer confusion about the uninsured nature of nondeposit investment products sold by insured depository institutions. In fact, most of the safeguards outlined in the Bill already are mandated by OTS regulation or incorporated into practice through policy statements, examination guidelines, or interpretation. Nevertheless, there are several differences between H.R. 3306 and existing OTS regulation and practice that I would like to identify here.

- H.R. 3306 prohibits an insured depository institution or its affiliate from sharing a similar name or logo with an affiliated mutual fund or with respect to any nondeposit investment product sold by, or on behalf of, the institution or any affiliate. (Existing similar name use would be grandfathered upon a regulatory determination that such use is not misleading.) The OTS currently prohibits thrifts or their affiliates from sharing the **same** name or logo with an affiliated mutual fund, but would allow the use of a **similar** name or logo, so long as the similarity is not confusing or misleading.

- H.R. 3306 conditionally allows persons who accept deposits (i.e. tellers) to refer customers to investment advisors and brokers, but prohibits tellers from receiving any referral-based compensation. The OTS, consistent with banking industry and SEC practice, allows tellers to receive a one-time nominal fee of a fixed dollar amount for each customer referral, so long as the fee does not depend on whether the referral results in a transaction.

- H.R. 3306 prohibits sales programs from providing compensation incentives for the sale of nondeposit investment products to any customer in lieu of a **more suitable** investment option for such customer. The OTS requires that incentive compensation programs must not be structured in such as a way as to result in **unsuitable** recommendations or sales being made to customers.

- H.R. 3306 requires that nondeposit investment products be sold only in a part of the insured depository institution's office that is **physically segregated** from the parts of the institution's office commonly accessible to the general public for accepting or withdrawing deposits. The OTS requires that mutual funds and other nondeposit investment products be sold in a physical location **distinct** from the area where retail deposits are taken and withdrawn.

- H.R. 3306 prohibits insured depository institutions from disclosing **confidential customer information** (financial information regarding any specific individual that has been derived from any record of the institution and that pertains to the individual's relationship with the institution) about any of the institution's customers to any affiliate of the institution without the customer's prior written consent. The OTS currently requires thrifts to comply with applicable state law in making such disclosures.

- H.R. 3306 provides that it is the sense of the Congress that the federal banking agencies should conduct **testing** of insured depository institution practices in the marketing, selling, etc. of nondeposit investment products. OTS staff has recommended that the use of testers be incorporated into the agency's examination guidelines.

The provisions summarized above have not been incorporated into our regulatory scheme. Some present issues that would benefit from further analysis. For example, the customer information issue is particularly difficult. Targeting certain customers for particular products is an efficient marketing device used by many entities. On the other hand, it is important that such information not be used inappropriately to take advantage of customers.

We would support an interagency effort to address these matters in a public notice and comment procedure with a view to exploring these issues further and to enhancing our existing regulatory regime. While we believe that mutual fund sales provide significant benefits to the industry, as I have already discussed, we recognize that to obtain the goals of minimizing customer confusion, further improvements to our regulatory and supervisory scheme are required.

V. NEW SUPERVISORY INITIATIVES

We have stepped up our supervisory efforts with respect to the sale of uninsured products in order to keep pace with the increased amount of sales activity that is taking place. The OTS has recently taken measures to capture data concerning mutual fund sales activity and consumer complaints, update our examination procedures to incorporate the new interagency statement and highlight this risk area.

A. Revision to the Thrift Financial Report (TFR)

OTS, along with the other banking agencies, has begun to collect information from thrifts about their mutual fund and annuity sales activity for each calendar quarter. The data collected include the dollar amount of mutual funds and annuities sold during the quarter through the thrift or its subsidiaries. In addition, we are collecting information about fee income from the sale and servicing of mutual funds and annuities.

This information will allow the OTS to analyze the volume of retail nondeposit investment sales, as well as to perform income comparisons with other thrift products. It will also assist examiners in identifying significant changes in a thrift's business strategy.

B. Tracking of Consumer Complaints

During 1993, OTS received only two consumer complaints regarding uninsured products sold on the premises of savings associations. While this number is small and both complaints were resolved to the satisfaction of the customers, it is disturbing because of the content of these complaints. Both complaints were from senior citizens who described abusive sales practices and pressure tactics from "overly aggressive" sales personnel. While interest income is especially important to those on fixed incomes, these individuals stressed throughout their complaint letters the importance of having FDIC-insured accounts. The messages contained in these two complaint letters echo some of the findings of the AARP survey on Bank Investment Products issued this January.

We anticipate that increased competition among financial institutions may increase the number of complaints we receive in the future. In anticipation of this occurring, we have altered our internal consumer complaint tracking system to specifically identify these types of complaints. This will assist our assigned consumer complaint specialists in each of our five regional offices to respond more efficiently to consumer problems in this area. In addition, this change will allow us to more quickly identify problem areas, patterns of abuse, and the

institutions involved and enable us to integrate the information in the examination process.

C. Examination Guidelines

OTS is currently updating its examinations handbook scheduled for publication in mid-Spring 1994. Examination guidelines covering securities brokerage currently found in our Service Corporation Regulatory Handbook, are being rewritten to reflect the new guidance we have issued in the past year, including the Interagency Statement. The examination procedures will be part of our examination guidance for annual full scope exams where the institution engages in such activity.

The additional information obtained through various sources including our consumer complaint tracking system, media reports and TFR data will provide insight into current and emerging problems. Examination follow up can occur during our regularly scheduled full scope examinations or through limited scope examinations for detected problems within a single institution. For industry patterns and emerging problems, limited scope examinations programs on a national or regional basis may also be warranted. In 1991, our West Region began a series of limited scope examinations for review of annuities sales after discovering a pattern of potential abuses and problems in sales taking place in savings association offices.

In the absence of any specific problems, OTS will include a review of securities sales in its full scope examinations and will address concerns through the examination process. Our goal is to ensure that savings associations have established, implemented and are in compliance with policies and procedures that effectively minimize customer confusion and result in safe and sound securities sales programs.

VI. CONCLUSION

As the financial services industry becomes more and more homogeneous, thrifts should be encouraged to remain competitive and permitted to pursue business strategies that balance their primary reliance on the cyclical housing market. Thrifts' ability to sell mutual funds and other uninsured investment products may contribute to the stability of the industry. We believe the fact that thrifts and their affiliates are subject to the federal securities laws as well as existing OTS regulations, together with the additional measures we have recently adopted, reduces the risks that accompany these activities to an acceptable, manageable level. Where problems arise, we intend, however, to take resolute action to prevent their recurrence. We will monitor this area closely and work with Congress to address any needs and concerns as they arise.

MUTUAL FUND AND OTHER NON-DEPOSIT INVESTMENT PRODUCT SALES

ORAL STATEMENT OF JONATHAN L. FIECHTER ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION March 8, 1994

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to present the views of the Office of Thrift Supervision on the sales by savings associations of mutual funds and other non-deposit investment products.

As the 4th witness this morning, much of the substance of my testimony has already been covered by the previous three panel members. I will try not to repeat too much what you have already heard this morning.

The subject of today's hearings -- the sale of mutual funds by banks and thrifts -- highlights the continuing blurring of distinctions among our various financial institutions. The public can now buy insured bank deposits at Merrill Lynch and Merrill Lynch mutual funds at their local bank. I have a desk drawer at home filled with check books issued by the various mutual funds I own. When I pay my bills at the end of the month, the large bills are all paid by checks drawn on a Philadelphia national bank. I don't have a checking account at that bank, however. Instead, it is linked to a Vanguard municipal bond fund that I opened over the telephone.

I am not unique. The current low interest rates on certificates of deposit have prompted many bank customers to transfer their funds out of deposits and into uninsured mutual funds and annuities. Since 1989, total investments in mutual funds have increased over 90%, while total deposits at banks and savings associations have experienced no net growth.

Not surprisingly, as a result, many banks and thrifts have initiated or stepped up sales of non-deposit investment products, such as mutual funds, in an effort to retain customer relationships, and, over the longer run, to generate fee income.

These activities are not without risk, both to the insured depository institution and to the customers who purchase these products. The objective of OTS policies and regulations is to reduce customer confusion and preserve safety and soundness in an effective and cost efficient manner.

In my statement today, I would like to summarize first the risks that arise when savings associations offer uninsured investment products and second, the steps we have taken to minimize these risks.

II. Risks

The key issue is the risk of **customer confusion**.

Consumer surveys conducted over the years have found that the public has incorrectly believed that money-market mutual funds that hold government securities and offer check-writing services are federally insured. Recent surveys suggest that the potential for such confusion increases when the products are sold through depository institutions. Customers purchasing investment products in depository institutions are more likely to view the product offered in the institution as being "safe" or "insured."

A survey released in November, 1993 by the SEC highlighted this public confusion. The survey revealed that of 1,000 households surveyed, a full 36% responded that mutual funds purchased **from a stockbroker are federally insured**. Let me emphasize that this misunderstanding related to funds purchased from a stockbroker, not a bank or thrift. When asked if they thought money market mutual funds sold through a bank were insured, 49% (or an additional 13%) responded yes. While the survey was crude, it suggests that first, a significant minority of the public is generally confused over whether or not mutual funds are federally insured. Second, it suggests that such confusion seems to increase when the (a) the product is similar to a traditional bank product and (b) it is purchased through a depository institution.

Customers also frequently do not understand the financial risks presented by the product. The public's risk of loss of principal from an investment in a mutual fund is substantially higher than his or her risk from a certificate of deposit. The risk of loss also varies among types of funds. Customers may not ask or be advised about the risk of loss in the investment. They may be uncertain whether the investment is appropriate for their needs. Certain vulnerable segments of the population may be specially targeted during marketing. While this is an effective marketing tool, it may contribute to the likelihood of confusion and inappropriate investment decisions.

Unfortunately, the risk of confusion may be greater when the customer purchases the mutual fund through a bank or thrift rather than through the mail or from a broker.

It is because of these risks that OTS has imposed a comprehensive regulatory regime consisting of several important components.

III. Regulation

First, thrifts and their affiliates that engage in the sale of uninsured product are subject to the federal securities laws. **OTS-supervised thrifts, unlike banks, are not exempt from the definitions of "broker" and "dealer" under the federal securities laws.** As a result, all thrift employees selling mutual funds are registered representatives working for registered broker-dealers. All of the requirements that govern broker-dealer and investment adviser activities apply to thrifts and their affiliates that advise or sell mutual funds.

As a result, thrifts that engage in uninsured product sales do so indirectly, either through service corporations or through leasing arrangements with third-party broker-dealers. The OTS has **service corporation** regulations governing the sale of non-deposit investment products. These regulations include an extensive list of safeguards. For example, sales activities must be conducted in an area of the thrift's office separate and distinct from deposit-taking areas. Tellers may refer customers to the separate brokerage area but are not permitted to be involved in any other way with investment product sales.

The OTS also has separate regulations governing the **sale in the offices** of a savings association of **securities issued by that savings association or its affiliates**. These rules include prohibitions on compensation, common sales areas, and fraudulent or misleading advertising. **The rules also require that customers sign a form certifying that they have received a copy of an offering circular and are aware that the security is not a deposit account and is not insured by the FDIC.**

Finally, the OTS joined with the other federal banking agencies in the recent issuance of the Interagency Statement on Retail Sales of Non-deposit Investment Products.

IV. New Supervisory Initiatives

While we believe that mutual fund sales by bank and thrifts provide a benefit to both the public and to the industry, we recognize that to obtain the goals of minimizing customer confusion, further improvements to our regulatory and supervisory scheme are required.

We have stepped up our supervisory efforts with respect to the sale of uninsured products in order to keep pace with the increased sales activity that is taking place.

The OTS has begun to collect information about thrift mutual fund and annuity sales activity for each calendar quarter.

The OTS also tracks consumer complaints regarding uninsured products sold on the premises of savings associations. During 1993, OTS received two consumer complaints about this activity. With the increase in fund sales, we anticipate that the number of complaints will increase in the future. We have, therefore, altered our internal consumer complaint tracking system to specifically identify these types of complaints.

V. H.R. 3306

You have asked for comments on H. R. 3306, the "Depository Institution Retail Investment Sales and Disclosure Act." OTS support the goals and objectives of this bill. In fact, many of the safeguards outlined in the bill already are mandated by the OTS. I have outlined in my written testimony provisions of H.R. 3306 that are not presently incorporated into OTS rules. We would support an interagency effort to further explore these issues through a public notice and comment proceeding.

<u>Conclusion</u>

In conclusion, as the financial services industry become more homogeneous, I believe that thrifts should be encouraged to remain competitive and permitted to pursue business strategies that balance their primary reliance on the cyclical housing market. I also believe it is critical for this to be accomplished in a safe and sound manner.

The sale of non-deposit investment products by thrifts and their affiliates is presently subject to a panoply of regulation and supervision, under the federal securities laws and through OTS regulation and the other measures I have described. We believe the existing structure reduces the risks that accompany these activities to an acceptable, manageable level. We intend to closely monitor this area and would be happy to work with this Committee to address concerns as they arise.

Thank you. I would be pleased to address any questions you may have.

STATEMENT

OF

R. SCOTT JONES

ON BEHALF OF

AMERICAN BANKERS ASSOCIATION

ON

THE SALE OF MUTUAL FUNDS BY BANKS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND DEPOSIT INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

MARCH 8, 1994

I. Introduction

Mr. Chairman and members of the Subcommittee, I am Scott Jones, Chairman of the Board and Chief Executive Officer of Goodhue County National Bank in Red Wing, Minnesota. I appear here today on behalf of the American Bankers Association. The ABA is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about 94 percent of ABA members are community banks with assets of less than $500 million.

Mr. Chairman, I commend you and your colleagues for holding these hearings and am delighted to be here today to discuss the sale of mutual funds by banks. Most importantly, I wish to share with you some of the many efforts the banking industry has undertaken to educate the consumer concerning these investments. We believe that these efforts in conjunction with the regulatory initiatives undertaken to date obviate the need for legislative action in this area.

At the outset, let me say that the ABA believes that all consumers should be fully informed abut their investment choices. As outlined in this testimony, our industry is taking extraordinary steps to both educate consumers and provide them with full disclosure. We fully support the strong efforts of our regulators in this area. Do we as an industry still have work to do in our education and disclosure campaigns? Yes, we do, and we are committed to following through quickly.

However, it is important to make sure all sectors of the financial services industry provide full information. We must ask what is going on with other financial services providers -- with securities brokers and insurance agents, for example. Recently banks have been under the microscope, but as discussed later in this testimony and as shown in the sample of advertisements contained in Appendix A, others in the financial services industry continue to blatantly mislead consumers, apparently with little concern being expressed by federal agencies or consumers groups.

The banking industry is truly undertaking a major consumer education and disclosure effort. ABA's efforts to inform consumers about the uninsured status of mutual funds sold through banks have reached literally millions of people, and we are going to keep at it. The banking industry is already subject to major regulation -- Truth-in-Savings -- on its deposit products and new, extensive guidelines on investment products. And if anyone thinks our regulators are not serious about this, I would ask them to review the Comptroller's new 40 page Nondeposit Investment Sales Examination Procedures for examiners to use in looking at bank sales practices.

Banks, in the meantime, are seeing billions of dollars flow out of our communities, to institutions with no base in the communities and certainly with no CRA requirements. Unfortunately in many cases, the consumer disclosures and practices of these institutions are in no way comparable to bank practices. In fact, any bank doing these types of things would likely find itself in serious regulatory trouble. For example, many bankers have

seen customer money go to brokers who leave the impression that insurance provided by the Securities Investor Protection Corporation ("SIPC") is much like insurance provided by the Federal Deposit Insurance Corporation ("FDIC"). On the next page is a current solicitation from a securities firm which shows just what we are talking about here. Recent newspaper articles have reported unbelievable sales practices in brokerage firms in such areas as tax shelters and mutual funds (See Appendix B). Other money flows from our communities to insurance agents using advertisements that promise the money is "guaranteed". The new banking agency guidelines will be enforced by over 7,500 examiners. How many examiners will be looking at the sales practices of our competitors?

We will continue to aggressively pursue our consumer education campaign, no matter what. We hope our competitors would join us in their effort. And we hope the federal government will look at the disclosure issue across the entire financial services industry.

As you are well aware, mutual funds are the fastest growing sector of the financial services industry. Total assets of all mutual funds have passed the $2 trillion mark[1] and, barring a turnaround on Wall Street, could match or even exceed total commercial bank deposits by the end of 1994.

[1] Source: Investment Company Institute

Attention All Clients
With Bank Held Retirement Assets

Effective December 19, 1993, FDIC insurance coverage on your aggregate retirement assets held at a bank will drop from $400,000 to $100,000. For many, a portion of retirement assets may be left uninsured by the FDIC. Why leave your hard-earned retirement assets at risk?

Oppenheimer has a solution. Your aggregate retirement assets held at Oppenheimer & Co., Inc. are insured through SIPC up to $500,000 per tax ID number. We have also purchased an additional $2,000,000 in coverage through a private insurer. Oppenheimer clients with assets whose market value is in excess of $2,500,000 are eligible to be considered for inclusion in the Preferred Client Program. Preferred clients are insured up to $25,000,000.

If the viability of your bank is a concern, you should consider moving your assets out of your bank and into an appropriate investment at Oppenheimer. Please contact your Oppenheimer broker with any questions you might have.

Oppenheimer & Co., Inc.
Retirement Services Department

Mutual fund growth is not limited to total assets. The number of funds offered has also grown exponentially. As of August, 1993, investors could choose among 4,320 funds, an increase of 666% from the 564 that existed at the beginning of the 1980s.[2]

America's commercial banks clearly want to be a part of this growing industry. The growing involvement of banks in this market shouldn't surprise anyone. Low interest rates are driving some bank customers to seek higher returns than those offered by traditional bank products, such as certificates of deposit. Banks like mine in communities across the country have seen our customers move their funds to mutual funds managed in New York, Chicago or Boston. Unlike banks, these mutual funds have no connection to our communities. Often times, these funds provide check writing services and are linked to credit card services. If this pattern continues and banks like mine continue to lose customers, where will the funds come from with which to make loans to businesses in our communities? Banks need to offer mutual funds, along with an array of other investment products such as U.S. government and municipal securities, in order to meet our customers demands and preserve those customer relationships. To fail to offer the products customers desire will surely mean further erosion of the role banks play in the economy as a whole, and reduce any chance of bringing deposits back into banks to make loans in our local communities.

---

[2] Source: Securities and Exchange Commission.

Moreover, commercial banks add significant consumer benefits by reaching a broader market, in part by employing their extensive branch networks for distribution of mutual funds. There are over 11,465 banks with more than 63,903 office locations spread across the country, serving both rural and urban markets.[3] This network of banks and branches provides an ideal distribution system to increase consumer convenience, decrease distribution costs, and make broader investment choices available to a wider market.

To keep our customers, however, is our paramount goal. Our members know that the only way to maintain those customer relationships is for banks to operate under the maxim, "What is good for the customer, is good for the bank." If we don't, our customers will take their business elsewhere. Consequently, it is in commercial bankers best interests to take appropriate steps to ensure that their customers understand that, by investing in mutual funds, they are investing in a noninsured investment that carries some level of risk. The ABA believes that the banking industry has been at the forefront of the financial services industry in educating consumers. Both the regulators and the industry itself have taken significant steps to ensure that consumers understand, among other things, that their investment is not insured by the FDIC and that it bears some degree of risk. I would urge my colleagues in other financial services provider industries to do no less.

---

[3] Source: Federal Deposit Insurance Corporation.

II. Bank Distribution of Mutual Fund Shares

Commercial banks involvement with the investment industry is not new. Indeed, commercial banks have been involved with the mutual fund business since the inception of that industry in the early 1920's. The many roles that banks have served[4] with respect to mutual funds have changed and grown so much over the years that banks now occupy a significant role in marketing mutual funds to consumers. Specifically, it is estimated that some 3,000 banks sell mutual funds and that some 14% of all sales of long-term funds are handled through banks.[5] The Investment Company Institute ("ICI") estimates that about one-third of all mutual funds were available for sale through banks during the first half of 1992.

Historically, the majority of bank sales of mutual funds came from the bank's trust department. Typically, banks use mutual funds for both short- and long-term investment of trust assets. For example, banks use money market mutual funds for trust cash investment and have expanded this service to corporate cash sweep accounts and brokerage account sweep programs.

More recently, however, banks have become very involved in delivering mutual fund products to the retail market. In a June, 1993 ABA survey of approximately 100

---

[4] For a discussion of the various roles banks serve with respect to mutual funds, see Appendix C, entitled An American Bankers Association Background Paper.

[5] Source: Investment Company Institute.

community bankers, defined as having assets under $250 million, fully 33% were offering mutual funds to their customers. Of the 67% responding that they did not offer mutual funds at the time of the survey, 45% anticipated doing so by 1995. These numbers correspond to those gathered through other surveys. For example, about a third to half of banks with less than $1 billion in assets (10,837 banks)[6] offer mutual funds, according to a survey conducted by American Brokerage Consultants of St. Petersburg, Florida.

Banks offer mutual funds to their retail customers through a variety of means. Some banks choose to offer their customers mutual fund brokerage through the bank.[7] Others offer mutual fund brokerage through an unaffiliated registered broker-dealer, while still others establish an affiliated registered broker-dealer to perform these functions. These brokers are registered with the Securities and Exchange Commission ("SEC") and various self-regulatory organizations, such as the National Association of Securities Dealers ("NASD"). As such, these brokers are subject to inspection by those bodies. Registered brokers are legally permitted to sell securities in a bank without the bank being a registered broker-dealer firm under a number of arrangements, including serving as dual employees of the bank and a third-party brokerage firm, as dual employees of the

---

[6] Source: Federal Deposit Insurance Corporation.

[7] It is clear that, under the federal banking laws, national, state-chartered nonmember and state-chartered member banks, their subsidiaries and bank holding companies are permitted to offer full securities brokerage services (order execution and investment advice) to both bank customers and the general public. Banks that engage directly in securities brokerage activities are exempt from registering as a broker-dealer under the federal securities laws. Bank subsidiaries and bank holding company affiliates are not.

bank and a bank-affiliated brokerage firm, or solely as employees of either the affiliated or unaffiliated brokerage firm. This latter arrangement is usually characterized by an agreement between the bank and the registered broker-dealer allowing the broker-dealer to lease lobby space in order to sell investment products to bank customers and the general public.

It is not known precisely how many banks offer consumers brokerage services directly through the bank. Our sense at the ABA is, however, that the number is relatively small. The bank brokerage business can be viewed as a continuum or spectrum with different brokerage arrangements aligned along that spectrum. At one end of the spectrum would be those banks that do not yet have sufficient business to justify the expense of employing a registered broker-dealer and, therefore, choose to offer brokerage services directly through the bank. At the other end of the spectrum would be banks, both large and small, that do have a sufficient book of business to justify hiring a registered broker-dealer. Exactly how the brokerage services would be offered to consumers, e.g., through either a dual employee arrangement or a leasing arrangement with either an affiliated or unaffiliated broker-dealer, is a business decision for each bank to make based on its individual circumstances.

Nor do we believe that the numbers along that spectrum are static. It is not uncommon to find that once a bank that is offering brokerage services directly through the bank builds its business, it will then determine to switch to a registered broker-dealer.

That determination is largely based on a cost-benefit analysis weighing such issues as the costs associated with hiring a broker against the bank's desire to build a broker-dealer sales culture.

Surveys seem to bear this out. A 1992 survey conducted by American Brokerage Consultants of commercial banks and savings institutions having total assets between $50 million and $10 billion (a total of approximately 7,700 institutions) showed that 39%, or just over 3,000 banks, offer both discount and full-service brokerage services to their customers.[8] Sixteen percent offered full-service brokerage.[9]

The survey also demonstrated that the percentage of institutions offering brokerage services increased with asset size; 31% of institutions with assets in the $50-$100 million category offered brokerage services, while 57% of institutions with assets in the $1-10 billion category offered brokerage services.[10]

This same survey demonstrated that 66% of banks offering brokerage services to customers did so through the use of a third-party vendor, while 33% did so using a bank affiliated broker-dealer. Not unexpectedly, banks in the smaller asset size categories tended to use third-party vendors, while banks in the larger asset size categories used affiliated broker-dealers.

---

[8] Source: American Brokerage Consultants Inc., St. Petersburg, Florida. This survey eliminated those banks with assets of more than $10 billion and less than $50 million.

[9] Id.

[10] Id.

While bank size may suggest whether a bank employs third-party or affiliated broker-dealers, it does not appear to be a factor in determining whether or not a dual employee arrangement is established. In a dual employee arrangement, the registered sales representatives are employees of both the bank and the registered broker-dealer. Compensation is paid through the bank. When a dual employee arrangement is not established, the registered sales representative is solely an employee of the registered broker-dealer. Sales compensation is paid by the brokerage firm and, as previously mentioned, the bank is compensated by way of a leasing arrangement.

Because the bank's paramount goal in offering investments, including mutual funds, to the retail public is to maintain the customer relationship, one would suspect that the majority of bank-brokerage arrangements involve the use of dual employees. The survey supports this hypothesis, 70% of all banks responding to this portion of the survey, regardless of size, stated that they used a dual employee arrangement to offer brokerage services to their customers.[11]

While the American Brokerage Consultants' survey is helpful in understanding what size banks offer brokerage services through registered broker-dealers, it does not address the extent to which banks offer brokerage services through the bank itself without the use of a registered representative. As discussed above, the ABA believes that the overall percentage of banks doing so is quite small. A small sample of community banks

---

[11] Id.

showed that fewer than 20% of the survey respondents indicated that they offered mutual funds through bank employees.

III. Consumer Protection

The ABA recognizes that consumers may be confused about the uninsured nature of many of their investments. As the survey released by the SEC late last year indicates, that confusion is not limited to investments sold through banks.[12] Thirty-six percent of all survey respondents believed that mutual funds purchased from a stockbroker are federally insured, while 28% thought that all mutual funds sold through banks were federally-insured like savings accounts and certificates of deposits. Curiously, 74% of all respondents correctly understood that you can lose money in a money market mutual fund, yet 49% still thought that money market mutual funds sold through banks are federally insured!

Consumer confusion can stem from any number of items. The surveys taken are not without their flaws, and must be read accordingly. At the same time, advertisements by nonbanks such as those attached (Appendix A) give consumers the impression that FDIC-type insurance protection attaches to their investment or that their investments can earn high returns without compromising the safety of that principal investment. Moreover, it is patently unclear from these advertisements just how these phenomenally

---

[12] SEC News Release 93-55, November 10, 1993.

high returns are calculated. Consequently, if a consumer wishes to comparison shop, he would be at a loss to compare yields and risks on mutual funds,[13] annuities, certificates of deposit and other investment products.

Consumer confusion can also stem from the fact that the term "bank" and "FDIC-insurance" have historically been linked. In order to sever that link when a bank sells investment products, including mutual funds, the federal bank and securities regulators and the industry itself have all joined together in an extensive consumer education effort. That effort has resulted in numerous pronouncements from the securities and bank regulators offering disclosure and other guidance to both banks and securities firms selling mutual funds and other nondeposit investment products through banks.[14]

These efforts have been very helpful in that they have provided regulatory leadership to the industry by setting out a general code of conduct for bank retail sales of uninsured investment products. As a result of these regulatory initiatives, the banking industry has refocused on ways it can improve bank retail sales of nondeposit investment

---

[13] Mutual funds advertisements are required to use specified standardized performance data. There is, however, no ability on the part of the consumer to compare performance data across product lines.

[14] Letter from Barbara Green, Deputy Director of the SEC's Division of Investment Management, dated May 13, 1993; Federal Reserve Board ("FRB"), SR 93-35 (FIS), June 17, 1993; Office of the Comptroller of the Currency ("OCC") BC-274, July 19, 1993; Office of Thrift Supervision ("OTS") TB 23-1, September 7, 1993; Federal Deposit Insurance Corporation, ("FDIC") FIL-71-93, October 8, 1993; Interagency Statement on Retail Sales of Nondeposit Investment Products, (FRB, FDIC, OCC, OTS) February 15, 1994 (hereinafter referred to as "Joint Interagency Statement"); OCC Bulletin 94-13, February 24, 1994.

products. It is incumbent on banks and other financial service providers to do a better job of educating and informing consumers about investments. The banking industry is committed to doing so, and has already taken a series of steps to ensure that our customers are not misled. Specifically, the ABA, in partnership with five other national trade associations,[15] has developed comprehensive industry guidelines covering bank retail sales of mutual funds and other uninsured products.[16] More than 25,000 copies of the industry guidelines have been distributed already, and we are about to go into another printing.

These industry guidelines will assist our members in complying with the regulators' requirements. All of the bank regulators require banks to develop internal policies and procedures regarding bank retail sales of nondeposit investment products. These policies and procedures will assist bank sales and supervisory personnel in operating the bank's retail investment sales business. In addition, internal compliance and audit personnel will rely on these policies and procedures in performing their job functions. The industry guidelines will assist our members in drafting their own internal policies and procedures for retail sales of nondeposit investment products.

Most importantly, it is anticipated that the industry guidelines will become industry practice. Although the guidelines do not have the force of regulation, the trade

---

[15] The Bankers Roundtable, Consumer Bankers Association, Independent Bankers Association of America, National Bankers Association and Savings & Community Bankers of America.

[16] Retail Investment Sales Guidelines for Banks, February 1994.

associations expect, as more and more bankers incorporate them into their own internal policies and procedures, that the guidelines will become industry practice. Ultimately, industry practice becomes enforced through regulatory examinations and the courts of law. In addition, the guidelines employ a self-executing enforcement mechanism by suggesting that bankers consider resolving any disputes with customers involving securities transactions through arbitration. A sample arbitration agreement is included in the guidelines.

Finally, it should be noted that while this hearing is limited to bank sales of mutual funds, the guidelines, like the bank regulatory pronouncements, are not similarly limited. In recognition of the fact that banks can and do offer their customers a wide variety of investment products suited to each customer's specific needs, the guidelines apply to retail sales of mutual funds, annuities, municipal securities, government securities and corporate debt and equity. Similarly, both industry and regulatory guidelines do not limit themselves to sales by banks. In fact, the guidelines apply not only to all bank sales but to any sales by third-party or affiliated broker-dealers/vendors. Thus, the guidelines govern retail sales by these entities and their employees where the sale occurs on the premises (bank floor/lobby) of the bank, results from a telephone call or written communication initiated from the premises of the banks, or results from a solicitation of bank retail customers.

A. Disclosure

The industry guidelines are a key component of the ABA's strategy to inform and educate the consumer about the uninsured nature of investment products and the risks associated with investing in those products. The cornerstone of the guidelines is customer disclosure. The guidelines call for four basic disclosures: the investment is not a bank deposit, is not an obligation of or guaranteed by any bank, is not insured or guaranteed by the FDIC and involves investment risk. That disclosure must be clear and prominent and must be included in all advertising and marketing materials and oral sales presentations. In addition, the four basic disclosures should be given in writing to the customer at the time the investment account is opened or at the time of initial purchase of a nondeposit investment product. A written acknowledgment form stating that the customer has read and understands the written disclosures and any sales charges or other applicable fees or charges should also be signed by the customer. The guidelines contain a sample written acknowledgment which is attached as Appendix D. Finally, the four basic disclosures should be included in all sales confirmations and periodic account statements generated by the bank or its affiliates.

These disclosures are obviously intended to eliminate any confusion customers may have concerning the uninsured nature of their investment product. Other disclosures would, of course, be appropriate depending on the particular nature of the investment product purchased.

It should be highlighted that the sample written acknowledgement contained in the guidelines attacks head-on the current confusion surrounding SIPC coverage. The aforementioned SEC survey seems to indicate that consumers are confused about the nature of SIPC coverage. Moreover, other evidence, including some of the advertisements attached to this statement, reveal the need to explain to consumers the nature of the SIPC protection. Consequently, the sample written acknowledgement contains a disclosure indicating whether or not the investments purchased are insured by the SIPC and explaining that "SIPC coverage is not the same as the federal deposit insurance provided by the FDIC". The disclosure then goes on to explain: "[i]t does not protect investors against a decline in the market value of securities. SIPC generally protects customers against the physical loss of securities if the broker/dealer holding the securities for the customer fails."

To our knowledge, the trade association guidelines are the only disclosure standards, regulatory or otherwise, to call for a written acknowledgment explaining SIPC coverage.[17] We invite our colleagues in the financial services provider industry to do the same.

The guidelines also call for elimination of customer confusion by reinforcing the regulators' pronouncements. Specifically, the industry guidelines require sales of

---

[17] The joint interagency statement would require comparable SIPC disclosures only if any written or oral representations concerning insurance coverage is made.

nondeposit investment products to take place in an area that is distinct from routine retail-deposit taking activities. Appropriate signage should be used to designate the investment sales location. Customer confusion is also sought to be eliminated by prohibiting employees serving as tellers from selling nondeposit investment products and from offering investment advice regarding such products.

In recognition of the fact that consumer education regarding mutual funds does not begin or end at the bank door, ABA has undertaken a number of other initiatives aimed at educating consumers that mutual funds, no matter where they are purchased, are not FDIC-insured. Since October, 1993, for example, ABA's mutual funds video news release has been seen by an estimated 2.4 million television viewers. This news release is aimed at informing consumers that while they can buy mutual funds through banks, mutual funds are NOT insured by the FDIC or guaranteed by the bank.

A similar news release tailored for radio has been heard by an estimated 81,000 radio listeners around the country. In addition, ABA has prepared an in-flight video announcement on mutual funds that aired on United, TWA and Continental video-equipped flights throughout the month of February. It is estimated that 3 million airline passengers have viewed the news release.

On February 1, 1994, the day the trade association guidelines were publicly released, a second ABA video news release was distributed via satellite to more than 700

commercial television stations. This second news release carried coverage of the trade association press conference releasing the guidelines. This second news release highlighted the fact that mutual funds are not insured and do carry some degree of risk.

ABA has also run nationwide a full-page consumer information advertisement on mutual funds (a copy of which is attached as Appendix E) in the February 1, 1994 edition of USA Today. A similar advertisement will run in the April edition of Reader's Digest.

ABA is also making a consumer information brochure, which clearly lays out the uninsured status and risks of mutual fund investments, available through our member banks. Already, ABA has distributed over 1,000,000 brochures to banks. In addition, ABA has distributed more than 300,000 mutual fund booklets prepared by the Office of the Comptroller of the Currency. Other consumer education initiatives are planned. In sum, ABA is in the process of a major industry effort -- reaching millions of people -- to inform our customers.

Clearly, ABA and the rest of the banking industry take our responsibility to our customers very seriously. ABA is committed to reaching bank customers with open, clear and complete information about mutual funds and other uninsured investments sold through banks.

B. Other Investor Protection Measures

Investor protection does not rest with disclosure. Clearly, disclosure is a most important element to ensure that customers understand what they are buying. Also very important is the need to ensure that sales personnel are adequately trained and qualified to offer investment advice concerning uninsured investment products.

Indeed, the bank regulators have stated that, "personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products [must be] adequately trained with regard to the specific products being sold or recommended. . . . If depository institution personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives."

Moreover, the bank regulators require that bank supervisory personnel receive training appropriate to that position. The regulators have also said that such training should also apply to compliance and audit personnel.

Similarly, the industry guidelines specifically call for appropriate licensing from the NASD, such as a Series 6 or 7. The guidelines also permit a NASD license equivalency certificate to be obtained. Finally, the guidelines state that banks should adopt continuing education requirements similar to those ultimately adopted by the securities

industry. Clearly, the intent of the guidelines is, to the extent possible, to have the same industry training and qualifications apply across the securities industry regardless of what sector of the industry is doing the selling. Consequently, the guidelines seek to model the banking industry training and qualification requirements after those of the securities industry.

Banks that employ the services of registered broker-dealers should only employ those individuals that have passed the appropriate NASD tests. Bank employees who are not employed by NASD member firms but are offering investment services to bank retail customers are not permitted, under the NASD's rules, to sit for their exams. ABA has sought that ability, but the NASD has thus far declined. Consequently, these bank employees have difficulty demonstrating their qualifications to sell investment products.

In response to this need for qualification and training, the ABA recently signed an agreement with Dearborn Financial Publishing Company to sponsor a nationwide educational program for bankers in the field of securities investment. Dearborn is a leader in training brokerage employees for NASD examinations. Under the ABA program, employees of banks in all regions of the country will be participating in a variety of courses and seminars on securities investments. Appropriate testing will be included with a certificate indicating that the holder has achieved proficiency in certain subject areas.

In addition to ensuring that sales personnel are adequately qualified and trained to offer investment products to consumers, the regulators have stated that sales personnel should adhere to fair and reasonable sales practices. If investment advice is given, sales personnel should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer based on the information disclosed to the customer.

In establishing a suitability requirement, the bank regulators have borrowed from the NASD's Rules of Fair Practice. Indeed, the recently released OCC examiner guidelines suggest that, at a minimum, the Rules of Fair Practice should be followed when making suitability determinations. The industry guidelines take a similar approach and contemplate that when disputes over whether a particular action taken satisfies suitability standards, the appropriate NASD Rules of Fair Practice and interpretations issued thereunder will govern. In this manner, no investor protection gaps will exist between investments sold by bank personnel and those sold by NASD-licensed representatives.

IV. Depository Institution Retail Investment Sales and Disclosure Act

The Depository Institution Retail Investment Sales and Disclosure Act, H.R. 3306, was introduced by Chairman Gonzalez and Representative Schumer on October 19, 1993. H.R. 3306 would regulate retail sales by banks of nondeposit investment products, including mutual funds and annuities. The ABA believes that, given the actions

taken by the regulators and the industry to date, no need exists for the Congress to enact H.R. 3306 or any other similar legislation.[18] Many of the provisions of H.R. 3306 are already contained in the federal securities laws or the federal banking regulations. It would indeed be a needless regulatory burden for the Congress to enact legislation that merely duplicates existing law.

For example, Paragraph (c) of Section 44 seeks to prohibit misleading and deceptive practices by specifying that an insured depository institution may not permit any person to engage in any practice, or employ any advertising, which could reasonably mislead people about the uninsured nature of, and the investment risk associated with, any nondeposit investment product sold or offered for sale by a bank.

This provision duplicates existing law. The antifraud provisions of the federal securities laws apply to all offers and sales of securities, including sales of mutual fund securities by banks. Therefore, under current law, it would be a fraudulent misrepresentation for a bank to mislead its customers about the uninsured nature of the mutual fund and the risk associated with investing in that product. Thus, if a bank were deemed to be guilty of violating the federal securities laws, a determination that, under current law, is left to the SEC, the bank regulators would refer the case to the SEC's enforcement division. In addition, the appropriate bank regulatory agency, under its

[18] Under separate cover, the ABA will provide, staff of the Subcommittee with a more detailed analysis of H.R. 3306.

authority to ensure the safety and soundness of the bank, can also bring appropriate enforcement actions, including seeking cease and desist orders or civil money penalties.

Establishing a duplicative antifraud provision under the federal banking laws could potentially put banks in the position of having to comply with two antifraud statutes that may, in practice, conflict with each other. Moreover, enactment of a statute that duplicates one already on the books may have the unintentional effect of creating a jurisdictional dispute between the appropriate agencies. Banks do not need to become embroiled in any more "turf wars" between regulators.

Another danger in enacting legislation that duplicates existing regulation, as many of the provisions in H.R. 3306 do, is that the regulators may very well lose their current flexibility to adjust regulatory rules to fit changing circumstances. For example, H.R. 3306 specifies the disclosures necessary to prevent customer confusion. By specifying the disclosures required, H.R. 3306 arguably takes away the regulators' flexibility to amend their joint agency statement to require new or revised disclosures depending on the then-current circumstances, new investment products or other developments unforeseen by the legislation.

The ABA would like to take this opportunity to express its specific opposition to one provision of H.R. 3306. Proposed new section 44(g) of the Federal Deposit Insurance Act would prohibit any bank or affiliate from using the name, title, or logo of

the bank which is the same as or similar to the name, title, or logo of any investment company or any nondeposit investment product either offered for sale by the bank or affiliate or with respect to which the bank or affiliate gives investment advice. This provision is obviously intended to get at those institutions that brand affiliated mutual funds with names or logos similar to that employed by the bank. The provision also would prohibit banks from marketing generic investment products under a similar name or logo.

With respect to the branding of affiliated mutual funds, the ABA believes that, with certain precautions, these mutual funds should be allowed to share some similarities in both name and logo. For example, Antarctica Bank advises the Antarctica Funds. The fact that the bank advises the funds must be disclosed under the federal securities and banking laws, as well as under the industry standards. What better way for a bank to inform the public that it serves as adviser to the fund than to brand the fund with a similar name or logo. This approach appears to have worked well for other financial services providers that have chosen to brand their insured bank with a name similar to that of their affiliated funds, e.g. Merrill Lynch Bank and Trust and the Merrill Lynch Funds.

The ABA does believe, however, that when similar names and logos are used by banks and affiliated funds, banks bear an obligation to make increased disclosures to their

customers to ensure that those customers understand that the fund is not FDIC-insured. In the above example, the Antarctica Bank would have an obligation to make increased disclosures concerning its funds. If Antarctica Bank did not adequately satisfy its obligation to make increased disclosures, it would be liable under both the federal securities and banking laws.

The ABA does not support, nor do the industry guidelines permit, banks and their affiliated funds sharing identical names. Thus, it would be improper for The Antarctica Funds to be called The Antarctica Bank Funds.

With respect to marketing generic investment products, this provision of H.R. 3306 effectively prohibits banks from offering investment type accounts, such as an asset allocation account, or sweep services under a similar name or logo. For example, the Antarctica Bank could not market its asset allocation account under the name the Antarctica asset allocation account. That account might invest in an array of mutual funds and other investment products. The mutual fund products may or may not include affiliated funds. Under the current regulations and industry standards, Antarctica Bank would have to disclose to its retail customers that the investment products are not FDIC-insured and bear some degree of risk. If the products offered under the asset allocation account include affiliated mutual funds, Antarctica Bank would be required to make increased disclosures. Despite these disclosures and all the other consumer protection measures undertaken by the industry, this provision, if enacted, would prohibit Antarctica

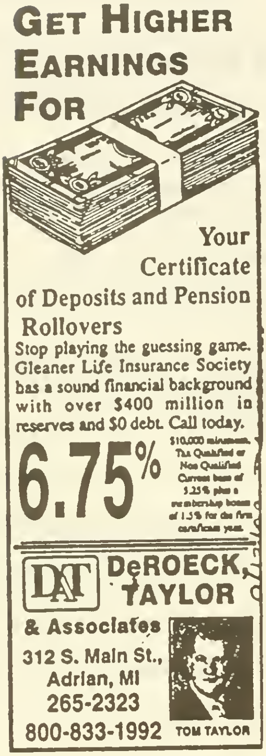
Bank from marketing that account under the Antarctica name. Surely, such an anticompetitive effect could not have been intended.

V. Conclusion

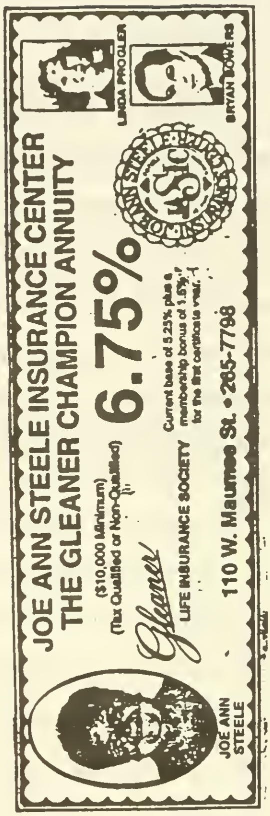
In closing, it has been a privilege to appear before this Subcommittee to discuss the various consumer education initiatives that the industry and the ABA have undertaken to date. The ABA pledges to continue those efforts and to further investor awareness generally concerning the uninsured nature of all investments, no matter where those investments are sold. We want to work with you, the regulators and others to take whatever additional steps are necessary to assure that investors are informed about the nature of mutual funds and other investment funds. The ABA does not believe, however, that legislation restricting the retail sales of mutual funds by banks is necessary or warranted.

(APPENDIX A)

THE DAILY TELEGRAM (Adrian, Michigan)



9/13/93



9/12/93

THE PENNSYLVANIA BUSINESS CENTRAL -- September 1993

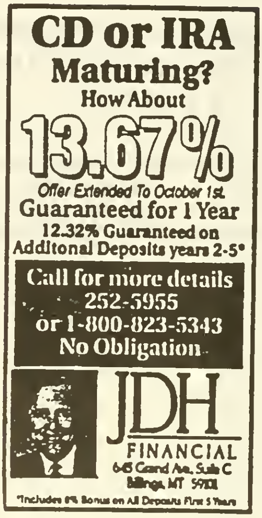
Tired of **LOW CD** Rates?

13.67% 1st Year Yield

Call American Insurance Marketing
814-266-8383
1-800-441-2120

THE BILLINGS GAZETTE (Billings, Montana)

September 17, 1993



THE PRAGUE TIMES HERALD -- August 26, 1993

(Prague, Oklahoma)

IF YOU OWN CD'S, YOU'RE TOSSING MONEY OUT THE WINDOW!

7.25%

C.D. ALTERNATIVE

INTEREST ON YOUR SAVINGS AND CD'S

Transfer IRA * More For Retirement

*100% TAX DEFERRED
*8.00% 4 YEAR AVERAGE INTEREST
*INSTANT LIQUIDITY
*CHECKBOOK ACCESS TO FUNDS
*PROTECTED & GUARANTEED

Call Gary Howell

1-800-654-6623

NO FEES OR OBLIGATIONS

THE VAIL DAILY -- August 27, 1993
(Vail, Colorado)

* CHAUSSEE FINANCIAL

Where is your money sitting ?

CD/Money Market........................2.1%
Average Mutual Fund (No Load).......9.12%
Annual Rate or Inflation 5.0%

We don't have to be a Rhodes scholar to figure this one out, do we?

* CALL CHAUSSEE FINANCIAL FOR FURTHER DETAILS 476-8206

* Member NASD, SEC, SIPC

(APPENDIX B)

THE WALL STREET JOURNAL. .... THURSDAY, FEBRUARY 24, 1994

Prudential Has New Woe: Unlicensed Brokers

By MICHAEL SICONOLFI
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK – Scores of Prudential Securities Inc. brokers are selling mutual funds and stocks without proper brokerage licenses in various states, internal Prudential compliance documents show.

As a result, Prudential ultimately could face the possibility of rescinding, or canceling, trades executed by the unlicensed brokers, regulators say.

The brokerage arm of Prudential Insurance Co. of America says it has a total of about 50,000 broker registrations for its roughly 6,000 brokers. "We've had our share of problems with registration," says John P. Murray, Prudential's director of corporate-risk management. "We're in the process of tightening up and fixing it. We're trying to make sure everybody in the place is licensed," he says, adding that he doesn't believe the problem is widespread.

To be sure, many large Wall Street brokerage firms have a number of unlicensed brokers at any given time. Indeed, the Securities and Exchange Commission last year found that the U.S. units of Japan's Big Four brokerage houses had, among other violations, unregistered brokers. But the issue is particularly problematic for Prudential, which is operating under intense regulatory scrutiny as a result of its limited-partnership woes.

Prudential Insurance recently commissioned a study by the accounting firm Coopers & Lybrand examining, among other things, the registration department at Prudential Securities. As part of the review, independent accountants will come in and study the firm's registration effort. Prudential also hired a former executive from rival Merrill Lynch & Co. to buttress its registration controls.

But Prudential hasn't yet informed regulators of the predicament, people familiar with the matter say. Instead, the firm appears to have paid brokers who improperly sold mutual funds without proper licenses, according to an internal memo.

"I have been informed by Bruce Karp of [Prudential's] Registration Department that trades will go through even if the [broker] isn't properly licensed," says an Aug. 16, 1993, memo from Anita Whelan, Prudential's mutual-fund compliance director. The memo, to Frank Giordano, Prudential's mutual-fund general counsel, added that Mr. Karp informed Ms. Whelan that the unlicensed brokers "are getting paid."

In her memo, Ms. Whelan didn't urge that any steps be taken to correct the situation. When asked yesterday whether the practice of paying unlicensed brokers for their trades is a problem, she replied: "That's a valid concern, but I don't handle licensing." She declined to comment further. Mr. Giordano didn't return a telephone call seeking comment.

Prudential says it dismissed Mr. Karp last year, after the memo was written, for performance reasons. Mr. Karp couldn't be reached for comment.

Prudential says the Whelan memo shows that the firm was concerned about the practice. "We're not in the business of paying commissions to people without licenses," said Mr. Murray. As for any discussions with regulators, Mr. Murray said: "I don't know whether we go around and make announcements to regulators about this. We have started on the process coming up with a whole bunch of ways to up the problems in registration. It isn't a secret around here, by any stretch."

Other documents show that some Prudential mutual-fund shareholders have been sold tax-free municipal-bond funds for their individual retirement accounts. (Investors aren't taxed on IRA funds until they start withdrawing money from such accounts.) This practice raises questions of investor suitability, the same issue at the heart of Prudential's limited-partnership debacle. As previously reported, federal and state regulators have accused Prudential of improperly selling $8.15 billion of partnerships in the 1980s.

The internal documents suggest that lax oversight and compliance aren't confined to Prudential's highly publicized partnership scandal.

Brokers and others who sell securities must pass required tests before doing business. These include so-called Series 6 tests for selling mutual funds and Series 7 tests for selling stocks. Besides these requirements, brokers must be registered in states in which their clients live, or where they are doing business. The internal documents show that some Prudential brokers are operating without passing their required series tests, and others without their proper state licensing.

Branch Managers Cautioned

At a meeting of branch managers in New York late last year, Mr. Murray said he told managers: "Nobody should have a laissez-faire attitude toward licensing – either you are or you're not, there's no in-between."

The issue of unlicensed brokers doesn't appear to be new at Prudential. A Feb. 22, 1990, memo entitled "Registration, Etc.: New Company Policy," told unlicensed Prudential brokers they would get paid if they arranged side deals with other brokers. "If you do a trade in a state that you are not registered in and turn the trade over to another broker for commission purposes, these commissions are nonrefundable. You can 'make a deal' with the broker to pay the commissions in a personal check, but New York will not journal the commissions over after you are approved in that state."

Prudential said it isn't familiar with the memo, which apparently was written by an Atlanta sales manager. But it said that practice wasn't company policy.

State securities regulators currently are examining the allegations of unlicensed Prudential brokers selling mutual funds and are preparing requests for document from Prudential on the matter, people familiar with the issue say.

Issue Is Viewed as Serious

Any failure to report problems of unlicensed brokers typically is viewed harshly by regulators. Speaking generally, Nancy Smith, New Mexico's securities director said: "If true, having unlicensed brokers sell securities is a very significant failure, and if it's compounded by a failure of the supervisory system and the lack of reporting on those violations, then that makes it a failure of even greater dimensions."

Ms. Smith added: "When you have unlicensed agents selling securities, one would expect the firm to offer full rescission to the investors."

On the municipal-bond issue, Prudential says it has taken steps to inform investors of the problem. In an Aug. 4, 1993, memo, Ms. Whelan, the fund compliance chief, said: "It has come to my attention that there may be instances when Prudential mutual-fund shareholders are holding Prudential municipal-bond mutual funds in IRA accounts."

Prudential says it is looking into the matter. The firm has prepared a letter to investors saying that as IRAs "include tax deferment until withdrawals commence, the choice of tax-free municipals are generally not as beneficial as other members of our mutual-fund family. In view of this, you may wish to consider taking advantage of our free exchange privilege into another member of our fund family."

(APPENDIX C)

BANKS AND MUTUAL FUNDS

AN AMERICAN BANKERS ASSOCIATION BACKGROUND PAPER

March 8, 1994

AMERICAN BANKERS ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C. 20036

Banks and Mutual Funds
An American Bankers Association Background Paper

Commercial banks have been involved with the mutual funds business since the inception of that industry in the early 1920's. The roles that banks have played with respect to mutual funds have both changed and grown over the years, paralleling the development and growth of the industry itself. That industry has grown from 426 funds with total assets of $45.9 billion in 1975 to over 4,320 funds with total assets in excess of $2 trillion in 1993.[1]

Mutual Funds, in General

Most mutual funds are open-end management investment companies as defined under the Investment Company Act of 1940 ("the '40 Act"). A mutual fund is organized for the purpose of buying, selling, trading, and owning securities. The company can establish one or more portfolios, or series of portfolios, with different objectives to appeal to various investment needs.

Investors, in the form of shareholders of the company, are sought to provide the cash to buy the portfolio securities; they receive their pro rata portion of the income derived from the ownership of securities as the return on their investment. Buying shares of a mutual fund is, therefore, just like buying the stock of any company--the "business" of the mutual fund just happens to be buying, selling, and owning securities, rather than, for instance, manufacturing automobiles.

Unlike corporate securities, however, there is no secondary market for mutual fund shares. Consequently, investors wishing to liquidate their investment in the mutual fund must request the fund to redeem their shares. Both purchase and redemption prices are expressed in terms of the per share net asset value ("NAV"), less any sales or redemption charges.

As a publicly registered company, the mutual fund has a board of directors (or a board of trustees, depending upon the legal structure its organization takes) that is responsible to the shareholders for the operation of the company. The board contracts with a number of specialists to provide the services necessary to operate the company and to comply with regulatory requirements. Exhibit 1 is a representation of the players involved in a mutual fund.

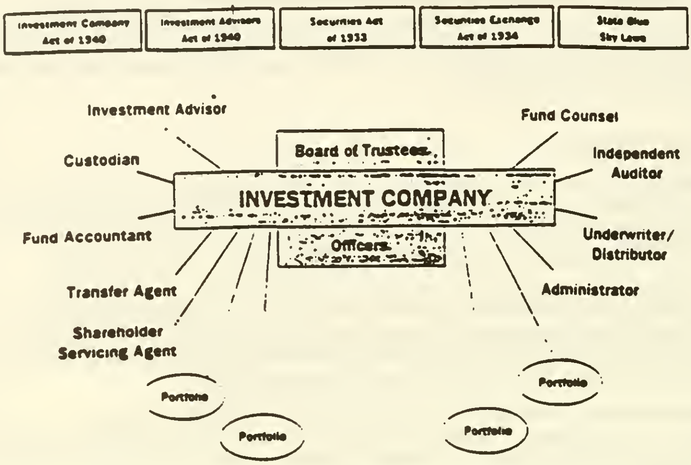
Registered investment companies are governed by the '40 Act. Although a mutual fund is established under the corporate or trust laws of a particular state, its operation and maintenance are regulated by the Securities and Exchange Commission (SEC) under the '40 Act. Mutual funds offer securities to the investing public on a continuous basis. This continuous primary offering of securities is effected under the Securities Act of 1933 ("the Securities Act"), which requires certain disclosures to be made through SEC filings and in the prospectus and statement of additional information provided to shareholders and prospective shareholders. Disclosures made under the Securities Act are intended to prevent fraud and misrepresentation. Shares of mutual funds must also be registered for sale in the states in which investors reside at the time of sale, under state securities or "blue sky" laws.

As with any other company, the board of directors has a fiduciary duty to operate the business for the benefit of the shareholders. Directors are elected by the shareholders annually. The '40 Act requires that at least 40 percent of the directors must be independent, or unaffiliated with the investment adviser, distributor, or any other service provider.

---

[1] Source: Investment Company Institute; Securities and Exchange Commission.

EXHIBIT 1
The Mutual Fund Players



The fund Board of Directors appoints officers of the company who are responsible to the Board for the day-to-day operations of the company in accordance with the policies set by the Board. For ease of operations, the officers are often employees of the administrator.

Investment Adviser

The investment company hires an investment adviser to make the decisions about what securities to buy and sell, in accordance with the investment objectives established by the Board and the various regulations that the fund is subject to, and based upon the investment adviser's expertise in the securities markets. Generally, investment advisers to mutual funds are required to be registered with the SEC under the Investment Advisers Act of 1940 ("Investment Advisers Act"). The investment adviser's contract must be reviewed and renewed by the Board every year, although a change in the adviser to a fund or an increase in the adviser's fees must be approved by a vote of the fund shareholders. The fees for advising a mutual fund are usually based upon some percentage of the NAV of the fund.

Commercial banks and bank holding companies are legally permitted to serve as investment advisers to mutual funds.[2] As investment advisers to mutual funds, commercial banks are specifically exempt from registration under the Investment Advisers Act. If, however, a commercial bank chooses to establish its investment advisory unit as a separate bank or bank holding company subsidiary, that subsidiary would be required to register with the SEC under the Investment Advisers Act.

It is not by sheer accident that banks have become investment advisers to mutual funds. Banks, typically through their trust department, have managed money very successfully for many years. Managing a mutual fund is not that much different that managing any other pool of funds. Consequently, many banks have leveraged their investment management expertise to serve as the investment adviser to mutual funds.

Custodian

The investment company hires a custodian to settle the securities transactions, hold the securities, and collect the income due. The custodian is responsible for the safekeeping of all the securities and cash owned by the fund.

Historically, banks have acted as custodians for the securities held in their trust accounts. The daily routine of trade clearance, securities safekeeping, income collection, and cash transaction processing for trust operations personnel is similar to the duties required for a mutual fund custodial arrangement. There are additional recordkeeping, regulatory, and specific procedural requirements of the mutual fund custodian. Although these requirements and associate costs become further complicated and magnified as the mutual fund expands its investments outside of the United States, the potential for fee income is still attractive. Custodial fees are usually priced based upon the number of transactions and number of shareholders per fund.

Commercial banks have always served as custodians to mutual funds. Indeed, Section 17(f) of the '40 Act and SEC Rule 17f-1 seem to recognize the importance of commercial banks serving as fund custodians. For those banks offering their own or proprietary funds, banks may, like non-bank affiliated mutual funds, self-custody their own funds in accordance with the SEC's self-custody rule, Rule 17f-2.

The Federal Reserve Board ("FRB") has stated, however, that where a bank holding company and its nonbank subsidiaries serve as both investment adviser and custodian or transfer agent (see discussion below) to a fund, the holding company and/or subsidiary "should exercise care to maintain at a minimal level demand deposit accounts of the investment company which are placed with a bank affiliate and should not invest cash funds of the investment company in time deposit accounts (including certificates of deposit) of any bank affiliate." 12 C.F.R. 225.125(i).

[2] National banks are permitted to serve as investment advisers under the National Bank Act. State-chartered banks should look first to their state law to determine their authority. The Federal Deposit Insurance Corporation ("FDIC") does, however, permit state-chartered banks to serve as investment advisers to mutual funds. Finally, the Federal Reserve Board ("FRB") permits bank holding companies and their nonbank subsidiaries to serve as investment advisers to mutual funds. The FRB has placed some limitations on that activity, however. Specifically, the FRB has stated that "[i]n view of the potential conflicts of interest that may exist, a bank holding company and . . . its . . . nonbank subsidiaries should not (1) purchase for their own account securities of any investment company for which the bank holding company acts as investment adviser; (2) purchase in their sole discretion, any such securities in a fiduciary capacity (including as managing agent); (3) extend credit to any such investment company; or (4) accept the securities of any such investment company as collateral for a loan which is for the purpose of purchasing securities of the investment company. 12 C.F.R. 225.125(g).

Fund Accountant

The fund accountant keeps track of the assets held, determines the market value of the assets and liabilities of the mutual fund, and calculates the NAV and certain per share data. The '40 Act requires that the NAV be calculated at least once every business day. The per share NAV is the price at which the fund will purchase from or sell shares to the fund's underwriter. When purchasing shares from the underwriter, investors may pay a sales charge in addition to the NAV per share, in which case the total paid is the public offering price. All known income and expenses that will affect the value of the fund are accrued on a daily basis so that the NAV per share is accurate within one cent per share, as required by the '40 Act, and represents the true value of the fund for all shareholders on a particular day.

There is no legislative or regulatory reason why any commercial bank or bank holding company cannot act as the fund accountant. Indeed, a survey of 24 bank holding companies offering proprietary funds (see discussion below) revealed that fully 50% were serving as fund accountant to their proprietary funds. This is an area, however, that is quite different from the typical bank accounting function. While, on the surface, it may appear that this function would be no different from the common or collective fund accounting banks do now, specialized systems requirements, as well as the knowledge and expertise required by the personnel performing these functions, can make for a significant up-front investment before a bank would be ready to offer these services to mutual funds.

Transfer Agent

The mutual fund transfer agent keeps track of the shareholders of the fund. Shareholder accounts contain not only name, address, tax identification number, account registration information, and number of full and fractional shares owned, but information concerning the shareholder's election to participate in special programs, offers, or features that the fund may offer. The transfer agent processes purchases and redemptions to the shareholder accounts, maintains the information in the account, effects distributions of dividends and capital gains to the shareholders in accordance with the provisions of the prospectus, provides tax information to the IRS and the shareholders, and provides reports as directed by the fund management. Many of the special features offered to shareholders by mutual funds, such as check writing, are processed by the transfer agent.

Transfer agents, including mutual fund transfer agents, are regulated by the SEC under Section 17A(c) of the Securities Exchange Act of 1934 ("Securities Exchange Act"). Banks and bank holding companies serving as transfer agent to any corporate issues must register with their appropriate regulatory agency (e.g., FRB, the Office of the Comptroller of the Currency ("OCC") or Federal Deposit Insurance Corporation ("FDIC")).

Banks and bank holding companies serve as mutual fund transfer agents. The FRB has, however, cautioned bank holding companies and their nonbank subsidiaries that serve as both investment adviser and transfer agent to a fund to exercise care with regard to fund deposits (see discussion above regarding custodians).

Shareholder Servicing Agent

The shareholder servicing agent answers questions and resolves problems concerning shareholders and the fund. Most mutual funds have a toll-free telephone line for the convenience of current and prospective shareholders in dealing with the shareholder servicing agent.

The function of overall shareholder servicing agent is rarely performed alone. It is usually a by-product of the transfer agent (who already has the shareholder account records needed to answer many shareholder questions), the investment advisory function (in those cases where the bank is advising a proprietary fund offered primarily to its customers, and is therefore anxious to maintain the primary customer contact), or the administrative function (where the administrator is closely monitoring the other services).

Banks may serve as shareholder servicing agent (or more properly, a sub-shareholder servicing agent) to the mutual funds they broker (see discussion below). In this way, the bank will be able to maintain the relationship with the customer by, among other things, answering customer inquiries, assisting the customer with required paperwork, and arranging for the purchase or redemption of shares.

Both the FRB and the FDIC staff have approved shareholder servicing agent as an appropriate function for bank holding companies and state-chartered nonmember banks.

Fund Counsel

Fund counsel is usually an outside law firm that acts as legal counsel to the fund and its Board. Fund counsel must be knowledgeable about the federal securities laws and the '40 Act and the Securities Act, in particular. Fund counsel must also be familiar with the various state securities laws and regulations, and the laws and regulations governing the activities of the various service providers.

Fund Auditor

The fund's auditors audit the financial statements of the fund annually and report their findings to the shareholders. In addition, the auditors report to the SEC on the internal controls of the fund.

For obvious reasons, the qualifications required of fund counsel and auditor do not lend themselves to bank involvement in these functions.

Underwriter, Distributor, and Sponsor

The underwriter (sometimes called the distributor or the sponsor) of the fund is a registered broker-dealer under the Securities Exchange Act. The underwriter has the responsibility for all share transactions with the fund. That is, when an investor wants to buy or sell shares, the underwriter deals directly with the fund, then completes the transaction with the investor. Although it is only for an instant in time, the underwriter initially owns every share of stock that is purchased or sold by the fund. The distributor may enter into agency relationships (called dealer agreements) with other broker-dealers in order to broaden the sales network for shares of the fund.

Section 16 of the Glass-Steagall Act prohibits national banks from underwriting and dealing in securities in bank ineligible securities (e.g., mutual fund shares, corporate debt and equity, and municipal revenue bonds). State-chartered member banks are similarly prohibited, while state-chartered nonmember banks are prohibited under other provisions of federal laws. Subsidiaries of national and state-chartered member banks may only engage in the activities permitted the parent bank. Hence, these subsidiaries are prohibited from underwriting and dealing in ineligible securities. Subsidiaries of state-chartered non-member banks are not so similarly limited.

Generally, the only way that national and state-chartered member banks can underwrite ineligible securities is to establish a bank holding company subsidiary under Section 20 of the Glass-Steagall Act. Section 20 provides that affiliates of national banks and state-chartered member banks may underwrite and deal in ineligible securities so long as the underwriting affiliate is not "engaged principally" in underwriting ineligible securities. The phrase "engaged principally" has been interpreted by the FRB to mean that no more than ten percent of the affiliate's revenues may be derived from underwriting and dealing in bank ineligible securities as measured against the affiliate's gross revenues. The affiliate's gross revenues would include revenues earned from underwriting and dealing in both ineligible and eligible securities (e.g., government and general obligation municipal securities) as well as revenues earned from other permissible activities, such as brokerage activities.

Although the FRB has approved a wide range of underwriting activities for Section 20 affiliates, the Board has not yet approved the underwriting of mutual funds. Because mutual funds are continually in underwriting, the general consensus has heretofore been that mutual fund underwriting activities cannot be folded into the Section 20 affiliate.

Since subsidiaries of state-chartered nonmember banks are not subject to Sections 16 and 20 of the Glass-Steagall Act, the Section 20 limits do not apply. In order to engage in underwriting and dealing activity, the state-chartered nonmember bank must have authority to do so under state law and the approval of the FDIC. In September 1992, the FDIC gave its approval to a state-chartered nonmember bank to underwrite mutual fund shares through a subsidiary.

Administrator

The administrator acts as the business manager of the fund. At the request and direction of the Board, the administrator performs many functions, which may include coordinating all the service providers, providing fund financial information to the Board, organizing and coordinating Board meetings, and providing various industry and market information needed by the Board to carry out its responsibilities.

National banks, state-chartered member and state-chartered nonmember banks, and bank holding companies are permitted to act as administrators to mutual funds. In addition, the FRB has, under certain circumstances, approved bank holding companies acting as administrators in conjunction with serving as investment adviser to the fund.

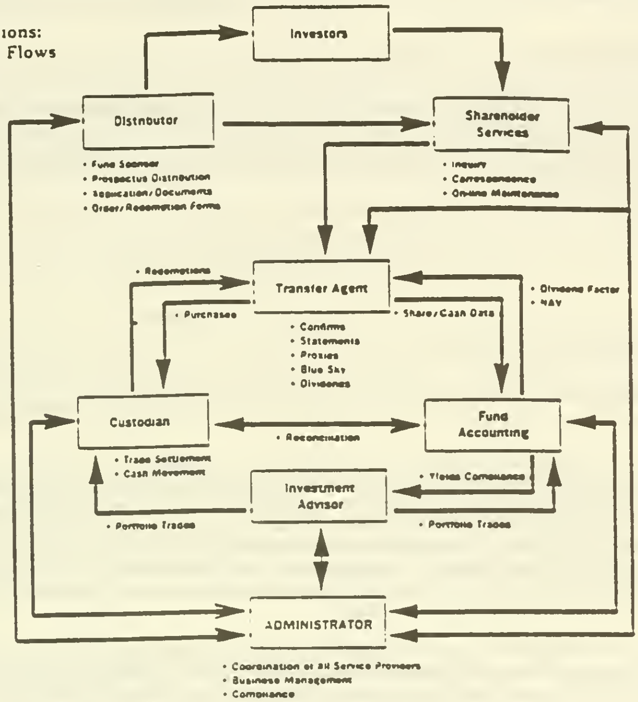
Exhibit 2 shows the typical flow of information among the various parties to a mutual fund.

Proprietary and Private Label Mutual Funds

Although banks are legally prohibited from underwriting, sponsoring or distributing mutual funds, banks can nevertheless offer their own or proprietary funds to their customers. Banks are able to do this by serving as the fund's investment adviser and providing any of the other authorized services bank management deems appropriate and commensurate with the bank's expertise. With respect to the role of fund underwriter/sponsor/distributor, bank management will hire an unaffiliated firm to provide the bank's proprietary fund with the necessary underwriting and associated services. Currently, 113, banks or bank subsidiaries offered 943 proprietary mutual funds. Total assets of these funds is about $204 billion.[3]

[3] See Lipper Analytical Services, Lipper Bank Related Fund Analysis (2d ed. 1993).

EXHIBIT 2
Fund Operations:
Relationship Flows



Private label mutual funds are funds that are established typically but not exclusively by a mutual fund family for the sole use of a particular bank client. The client bank may determine that it does not have the requisite investment advisory expertise or other resources to establish a proprietary fund but, nevertheless, wishes to establish its own mutual fund for trust or other customer relationships. Generally, the bank client will name or brand the fund so that the fund is or will become associated with the bank. Because the client bank does not provide the investment advice to the mutual fund, the fund provider will perform that service or it will hire an outside investment manager. Both banks and

nonbanks offer their bank clients the ability to establish private label funds. It is not uncommon to find that private label funds make up one or more funds in a multiclass portfolio or master-feeder structure.[4]

Delivery Mechanisms

Commercial banks are becoming increasingly involved in marketing both proprietary and third-party mutual funds to their customers. According to recent surveys, banks sold $23 billion, or 14% of all stock and bond funds in the first half of 1992.[5] During this same time period, 33% of all mutual funds had sales through banks.[6] Clearly, banks are becoming an important force in selling mutual fund shares to the investing public.

---

[4] SEC Chairman Levitt described multiclass portfolios and master-feeder structures in the following manner:

"In a multiclass arrangement, a mutual fund offers portfolios that have several classes of shares, with each class subject to a different distribution arrangement, but representing interests in the same pool of investments. The classes are often targeted to different groups of potential shareholders and usually differ with respect to distribution expenses and the way shares are purchased and redeemed. The multiclass structure enables a fund to sell different share classes through different intermediaries, such as banks, brokers, and financial planners. These multiclass arrangements also give investors various options regarding the types of serv services they receive and the method of paying distribution charges.

In a master-feeder system, a fund sponsor organizes and offers separate fund portfolios. These feeder portfolios are identical except that, like the classes in a multiclass structure, each is sold to different groups of similarly situated customers, who may have different investment constraints and may require different services. These feeder portfolios do not invest directly in securities, but rather invest in a single master fund, which, in turn, invests in securities. In essence, this structure unbundles the usual investment company functions into two components. The activities relating to investment management and custody are performed by the master portfolio, while the activities relating to marketing, distribution and shareholder servicing are performed by the feeder and tailored to meet the needs of its investors.

See Testimony of Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission Before the Subcommittee on Securities of the Senate Committee on Banking and Urban Affairs, November 10, 1993.

[5] Source: Investment Company Institute.

[6] Id.

Trust Assets

Historically, a number of bank proprietary funds were started by converting the bank's employee benefit collective funds to mutual funds of the same investment style and objective. In addition to the legal procedures required to establish the mutual fund, issues raised by the Department of Labor ("DOL") under the Employee Retirement Income Security Act ("ERISA") must be addressed prior to the conversion of employee benefit funds. The bank portfolio managers managing the collective funds generally would manage the proprietary mutual funds, and the trust operations area would implement some additional controls and procedures to maintain custody of the assets of the mutual fund.

Today, many banks have converted their employee benefit funds to proprietary mutual funds. Typically, a conversion involves an exchange of units of the employee benefit fund for securities in the mutual fund. These exchanges have potential tax consequences, which is the primary reason that banks have typically not converted their common trust funds consisting of personal trust assets.

A provision permitting tax-free conversions of common trust funds to mutual funds was included in both tax bills passed by Congress in 1992. That legislation was ultimately vetoed by President Bush for reasons wholly unrelated to this provision. Tax free conversion is a part of the House Ways and Means Committee approved technical corrections legislation, H. R. 3419. More recently, legislation (H.R. 3631) has been introduced in the House that would allow a bank to convert its common trust funds into one or more mutual funds without any adverse tax consequences to the common trust fund participants.

In this connection, the OCC has taken the position that it would be a conflict of interest if a bank invests fiduciary assets in a mutual fund for which it acts as an investment adviser and receives fees for that service, unless lawfully authorized by the terms of the instrument creating the relationship, court order, or local law. OCC Trust Interpretation No. 234 (September 21, 1989). In response to the OCC's position, state statutes have been modified to allow fiduciary assets to be invested in proprietary mutual funds. To date, some forty states have enacted legislation that would allow such investments for fiduciary assets.

Typically, banks use their proprietary mutual funds for both short and long-term investment of trust assets. For example, banks use money market mutual funds for trust cash investment and have expanded this service to corporate cash sweep accounts and brokerage account sweep programs.

Retail Market

More recently, banks have become very involved in delivering both third-party and proprietary mutual fund products to the retail market. It has been estimated that over 3,000 banks are now offering or brokering mutual funds to their retail customers. In a recent ABA survey of approximately 100 community banks, defined as having assets under $250 million, fully 33% were offering mutual funds to their customers. Of the 67% responding that they did not offer mutual funds at the time of the survey, 45% anticipated doing so by 1995.

It is clear that, under the federal banking laws, national, state-chartered nonmember and state-chartered member banks, their subsidiaries and bank holding companies are permitted to offer full securities brokerage services (order execution and investment advice) to both bank customers and the general

public. Banks that engage directly in securities brokerage activities are exempt from registering as a broker-dealer under the federal securities laws. Bank subsidiaries and bank holding company affiliates are not.

While some banks choose to offer their customers securities brokerage through the bank, most have, however, opted to offer their customers securities services through registered broker-dealers. These brokers are registered with the SEC and the National Association of Securities Dealer ("NASD"), and, as such, are subject to inspection by those bodies. Registered brokers can sell securities in a bank without the bank being a registered broker-dealer firm under a number of arrangements, including serving as a dual employee of the bank and a third-party brokerage firm, a dual employee of the bank and a bank-affiliated brokerage firm, or solely as an employee of either the affiliated or non-affiliated brokerage firm.

SAMPLE INVESTMENT PRODUCT ACKNOWLEDGMENT

By my signature below, I acknowledge that I have read and understand the following features of my investment that have been checked by the Designated Sales Representative as applicable:

- ☐ The investment products I am purchasing are not bank deposits and are not obligations of, or guaranteed by, any bank. These products are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.
- ☐ Where appropriate (for example, mutual funds and equities), I have received a current prospectus and understand the sales charges and other applicable fees or charges as disclosed in the prospectus.
- ☐ Sales charges and other applicable fees or charges regarding other investment products purchased have been disclosed.
- ☐ I understand that the investment products purchased are subject to investment risk, including possible loss of principal.
- ☐ Although payment of principal (at maturity) and interest on securities in U.S. government funds is guaranteed to the fund, the market value of the shares will fluctuate with rising or declining interest rates.
- ☐ An investment product's past performance should not be considered an indication of future results.
- ☐ Procedures for redeeming, surrendering or selling my investment may vary, depending on the investment selected, and have been disclosed.
- ☐ The investment products I am purchasing ARE/ARE NOT insured by the Securities Investors Protection Corporation ("SIPC"). SIPC coverage is not the same as the federal deposit insurance provided by the FDIC. It does not protect investors against a decline in the market value of securities. SIPC generally protects customers against the *physical loss* of securities if the broker/dealer *holding* the securities for the customer fails.

Name(s) as shown on account ______________________________

Account # ______________ Amount of initial investment ______________

Investing in ______________________________

Signed ______________________ Signed ______________________

Date ______________

Recommended: Form to be in Triplicate (Copies to Accountholder, Branch Office, and Central Office)

(APPENDIX E)

A MESSAGE OF (MUTUAL) INTEREST

An Open Letter to Consumers about Mutual Funds and Other Uninsured Investments

Many banks now sell mutual funds as a service to their customers. In fact, more than 15% of the mutual fund sales in the country last year were at banks, providing bank customers with more alternatives to traditional insured financial services.

Mutual funds may or may not be an appropriate investment for you. You owe it to yourself to be fully informed before you decide and to talk to your local banker about your investment goals.

Remember that, no matter where or from whom you buy it:

- ✓ **A mutual fund is not a bank deposit.**
- ✓ **A mutual fund is not an obligation of, or guaranteed by, any bank.**
- ✓ **A mutual fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.**
- ✓ **A mutual fund involves investment risk, including the possible loss of principal.**

Today, the American Bankers Association, represeoting banks large and small from coast to coast, will join with the five other national trade associations for banks and savings associations and unveil guidelines for financial institutions selling mutual funds.

The guidelines will help ensure that any person considering a mutual fund investment from a bank receives clear and full disclosures regarding the nature of that investment — its risks as well as its rewards.

We want to help you be informed. For a copy of our concise brochure explaining the differences between insured deposits and uninsured bank financial products, write: Mutual Funds Brochure, American Bankers Association, 1120 Connecticut Aveoue N.W., Washington, D.C. 20036.

As seen in USA TODAY, February 1, 1994

RETAIL INVESTMENT SALES

Guidelines for Banks

A Joint Project of:

American Bankers Association
•
The Bankers Roundtable
•
Consumer Bankers Association
•
Independent Bankers Association of America
•
National Bankers Association
•
Savings & Community Bankers of America

FEBRUARY 1994

CONTENTS

EXECUTIVE SUMMARY

Working together, the nation's six banking trade associations have prepared voluntary guidelines for bank retail sales of mutual funds and other nondeposit investment products. The guidelines are intended to complement the four separate sets of guidelines and policies issued by the bank regulators in 1993.

The guidelines explain how to put many of the regulators' recommendations into action. They address the appropriate setting and circumstances for bank sales of nondeposit investment products and suggest proper disclosure policies for communicating the uninsured nature of these products to customers, the extent to which certain employees may become involved in such transactions, acceptable employee qualifications and training, and a number of other important considerations.

The Purpose

By drafting guidelines in this area, the six trade associations intend to accomplish four primary results:

1. Enhance Customer Protection

These guidelines demonstrate the banking industry's commitment to making its customers aware that mutual funds are not FDIC-insured. They place a strong emphasis on oral and written disclosure and on ways to help customers understand the uninsured nature of investment products.

2. Complement Regulatory Policy

These guidelines complement the four separate policies adopted by the regulators. The regulators' policies are not identical; one set of guidelines that will cover all banks and thrifts would be helpful.

3. Help Banks Comply

These guidelines can assist banks in complying with their regulators' requirements. For example, banks need to develop internal policies and procedures regarding bank retail sales of nondeposit products. The industry guidelines are designed to help banks do that by raising issues that must be considered.

4. Encourage Training and Qualifications

The industry guidelines suggest appropriate training and qualifications for bank sales personnel. Training and qualifications should be incorporated into bank policies and procedures.

Summary

Oral and Written Disclosure

Customers should be informed both orally and in writing at the time of account opening or initial purchase of a nondeposit investment product that such products—

- are not bank deposits,
- are not obligations of, or guaranteed by, any bank,
- are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and
- involve investment risk, including the possible loss of principal.

Signed Disclosure

The regulators have stressed the importance of keeping customers fully informed of the nature of nondeposit investment products. The industry's guidelines provide a sample form acknowledging that the customer has read and understands the written disclosures.

Advertising and Promotion

All advertising and promotional, marketing, and sales materials should contain conspicuous and prominent notice of the uninsured nature of such investment products. In order to be conspicuous and prominent, the disclosures should be appropriately placed and in appropriate style and size of type so that the disclosures will not escape the customer's attention. For example, disclosures are not conspicuous and prominent if they are lost in the middle of a multi-page document or if they are in typeface that is too small relative to the other typefaces used in the document.

Location

Sales of nondeposit investment products that occur in a bank should, to the extent permitted by space and personnel considerations, take place in areas that are physically separate and/or distinct from routine deposit-taking activities. Signs and/or some other means may be used to distinguish any investment sales area from the areas where routine retail deposit-taking functions occur.

Setting and Circumstances

Employees acting as tellers should be prohibited from selling nondeposit investment products and from offering investment advice regarding such products. Tellers may refer customers to the appropriate location and/or individual in the bank and may respond to customer questions regarding general procedures for purchasing nondeposit investment products from the Designated Sales Representative ("DSR").

Nondeposit investment products should be sold only by qualified personnel (for example, properly trained bank employees, registered representatives, or licensed annuities salespersons). Investment advice should be given only by qualified, and if required, licensed personnel.

Employee Qualifications and Training

Bank management, DSRs, and audit and compliance personnel involved with the bank's investment product program should demonstrate competence appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures.

When appropriate and possible, DSRs should obtain an appropriate NASD license, such as a Series 6 or 7. A NASD license equivalency certificate may also be appropriate. Furthermore, the guidelines state that background checks for all new DSRs who will be engaged in the offering and/or sale of nondeposit investment products are strongly recommended. Reviews of new employees with previous securities or insurance industry experience should include a check with appropriate authorities for prior disciplinary actions.

Industry trade groups should assist their members in obtaining appropriate training in the sale of nondeposit investment products.

Employee Compensation and Referral Fees

Suitability, not compensation, should guide sales of nondeposit investment products. Compensation for the sale of nondeposit investment products should be structured to avoid incenting the sale of unsuitable products. DSRs should be free to offer customers a choice of investment products that provide different levels and types of compensation. However, sales personnel should not favor or disfavor the sale of a particular investment company, group of investment companies, or insurance company product based solely on receipt of brokerage commissions or other incentives.

Compensation to tellers and other bank employees for referrals is permissible but should not be based on the success of the referral in generating a sale of a nondeposit investment product.

Bank Management and Board of Directors Oversight

A bank should establish and maintain written policies and procedures regarding retail sales of nondeposit investment products. Such policies and procedures should encompass third-party and affiliated vendor sales, sales of proprietary products, and sales of both third-party and proprietary products by bank personnel, as applicable.

Bank management should establish, maintain, and enforce a system to manage its retail investment activities and those DSRs involved with offering nondeposit investment products to the retail public. Such a system should be reasonably designed to achieve compliance with applicable banking, securities, and insurance laws and regulations. Final responsibility for proper oversight should rest with bank management.

A compliance program, independent of investment product sales and management, should be established. The program should be capable of verifying compliance with applicable laws.

SCOPE OF COVERAGE

These guidelines apply to domestic retail sales of nondeposit investment products (including marketing and promotional activities) to individuals by or through any FDIC-insured depository.

FDIC-Insured Depository

This term includes FDIC-insured commercial banks, savings banks, and savings associations (hereafter referred to collectively as "bank"). Thus, these guidelines cover retail sales (including marketing and promotional activities) by employees of such banks, whether made on or off the premises of the depository. This also includes retail sales (including marketing and promotional activities) conducted by employees of the bank by telephone, through the mail, or at the residence or place of business of the prospective customer.

Bank-Related Sales

These guidelines apply to domestic retail sales (including marketing and promotional activities) by employees of corporate entities related to the bank. Related corporate entities include affiliates as defined in the Bank Holding Company and Savings and Loan Holding Company Acts. Related corporate entities also include companies that pay to the bank or its employees a direct monetary benefit or other compensation for the purpose of selling nondeposit investment products to bank customers. For example, third-party networking arrangements are included in this category. The guidelines govern retail sales by all such entities and their employees where the sale occurs on the premises (bank floor/lobby) of the bank, results from a telephone call or written communication initiated from the premises of the bank, or results from a solicitation of bank retail deposit customers.

On the other hand, these guidelines do not apply to retail sales conducted through bank affiliates where the sale does not occur on or through bank premises or otherwise has not resulted from solicitations directed to retail deposit customers of the bank. These guidelines are intended to work in tandem with the rules of the Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers, Inc. ("NASD"), to the extent those rules are applicable. Special attention should be given to *NASD Notice to Members 93-87, December 1993.*

Designated Sales Representative

Designated Sales Representatives ("DSRs") are personnel who are authorized and qualified to sell nondeposit investment products. As such, a DSR can be a properly trained bank employee, a registered representative, or a licensed annuities salesperson.

Nondeposit Investment Products

These guidelines apply to the retail sale, promotion, and marketing of: mutual funds, annuities, commercial paper, securities (including bank and bank-affiliated securities), and all other investment products not insured by the Federal Deposit Insurance Corporation ("FDIC"). These guidelines do not apply to United States savings bonds.

Retail Sales

These guidelines apply to sales to individuals. Such sales are defined as "retail sales" and include promotional and marketing activities that are aimed at either deposit customers or the general public. Excluded from the coverage of these guidelines are the following:

Sales to sophisticated customers. These guidelines do not apply to "sophisticated" customers. Such customers are defined to mean: institutional investors; individuals with a net worth or individuals who with their spouse have a joint net worth exceeding $1 million; and individuals with net income of $200,000 in each of the two most recent years or who with their spouse have joint income in excess of $300,000 in each of those years and who have a reasonable expectation of reaching the same income level in the current year.

Large denomination products. Sales of large denomination bankers' acceptances, commercial paper/master notes, repurchase agreements, variable rate demand notes, or other money market instruments, whether or not issued or guaranteed by the insured depository or its affiliates, are not covered by these guidelines. Such investments are recognized by the federal regulators as being sold to sophisticated investors, owing to their large minimum denominations, and are, consequently, not deemed to be "retail" in nature.

Fiduciary activities. Sales to fiduciary accounts (that is, where the bank exercises substantial investment discretion) are not covered by these guidelines but are covered by applicable fiduciary laws.

APPLICABLE LAW AND REGULATION

Bank retail sales of nondeposit investment products are regulated at both the federal and state levels under several different regulatory schemes. The following is an attempt to briefly outline applicable law and regulation. This outline is not a substitute for advice of counsel. Competent legal counsel should be consulted before embarking on any program offering nondeposit investment products to the retail market.

Securities

Retail sales of securities by national banks are subject to the rules and regulations of the Office of the Comptroller of the Currency ("OCC"). Retail sales of securities by state-chartered members of the Federal Reserve System or by insured state-chartered non-FED member banks are regulated by the Federal Reserve Board ("FED") or by the FDIC, respectively. Retail sales of securities by federally-chartered and insured state-chartered savings associations are regulated by the Office of Thrift Supervision ("OTS").

All banks and bank affiliates that engage in the retail sale of securities are subject to the antifraud provisions of the federal securities laws. For these purposes, the federal securities laws include the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940.

Should a bank employ a third-party broker-dealer or even a bank-affiliated broker-dealer, the broker-dealer's activities would be subject to the jurisdiction of the SEC, as well as a securities self-regulatory organization such as the NASD or the New York Stock Exchange ("NYSE"). Thus, for example, retail sales of securities by third-party broker-dealers on the premises of a national bank could be subject to the rules and regulations of the OCC, the SEC, the NASD, and/or the NYSE.

Finally, and not to be overlooked, are state banking and securities laws. While the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") provides that, without prior FDIC approval, state-chartered banks could not engage as principal in activities prohibited to national banks, it is conceivable that state banking laws could prohibit state-chartered banks from engaging in certain activities permitted for national banks. In addition, state securities laws must also be consulted.

Annuities

Annuities are financial instruments that may also be deemed to be either an insurance product and/or a security product, depending upon the specific law applicable and the nature of the annuity contract. Generally, variable annuities are considered securities, and fixed-rate annuities may be considered either financial instruments or insurance products; however, legal counsel should be sought if there is any question in making this determination or in identifying applicable licensing requirements.

In this last regard, special care should be used when the bank involved is federally-chartered to ensure whether federal law, as applied by the appropriate federal regulatory agency, is consistent with or preempts state law. Again, consultation with legal counsel is recommended.

LOCATION OF SALES

To foster customer understanding that nondeposit investment products are not FDIC-insured, this and the following section on Setting and Circumstances are to be read together.

General

Sales of nondeposit investment products that occur in a bank should, to the extent permitted by space and personnel considerations, take place in areas that are physically separate and/or distinct from routine retail deposit-taking activities regardless of whether the sales are made by bank employees, an affiliated broker-dealer, or a third-party broker-dealer.

Signage

Any area designated as the investment sales location, including a new account area, should be clearly and prominently identified with signs and/or displays that distinguish this area from routine retail deposit-taking functions.

> For example, signs in the platform area could indicate "Investment Center" or list the name of the broker-dealer firm conducting investment sales. The investment sales area may be part of a lobby when such area is distinguished from the retail deposit-taking functions area in the same lobby. Walls, handrails, shelves, display units, plant arrangements, furniture and equipment, signage, or some other means may be used to distinguish the investment sales area from the retail deposit-taking functions area.
>
> Use of visual illustrations are acceptable means to identify an area where investment sales occur. For example, one bank has placed the FDIC logo in a circle that is slashed through to indicate the lack of such coverage. (*See* the next page.)

Comptroller Ludwig gave this example in the fall of 1993 of a format for "good disclosure" for mutual fund sales. Of course, banks may design their own format.

MUTUAL FUNDS
AND ANNUITIES...

- **are NOT FDIC insured**
- **are NOT obligations of Anytown Bank**
- **are NOT guaranteed by the Bank**
- **involve investment risk, including possible loss of principal**

Key Element:
Conspicuous Type

Key Element:
Essential Information

Key Element:
Clear Message

*Note: *These disclosures do not conform precisely to those recommended in these guidelines.*

Written Policy

Written policies governing the sales of nondeposit investment products that occur or are initiated on bank premises should take into account in general terms the location(s) within the bank at which these transactions will occur.

Regulatory Designation of Location

Bankers should note that, if sales of nondeposit investment products are conducted by a registered broker-dealer, the area of the bank in which the sales occur may have to be registered with the NASD, depending on the type and extent of activities being conducted.

SETTING AND CIRCUMSTANCES

Tellers

Employees while acting as tellers should be prohibited from selling nondeposit investment products and from offering investment advice regarding such products.

Referrals

Tellers may refer customers to the appropriate location and/or individual in the bank for the sale of nondeposit investment products.

Inquiries

Tellers may respond to customer questions regarding general procedures for purchasing nondeposit investment products from the designated sales representative. Tellers are prohibited from discussing the merits of particular investment products.

> For example, tellers may say: "If you wish to discuss an investment, you may speak with Mr. or Ms. X, whose desk is located...."

Designated Sales Representatives

Nondeposit investment products should only be sold by qualified personnel (for example, properly trained bank employees, registered representatives, or licensed annuities salespersons). Investment advice should be given only by qualified, and if required, licensed personnel. DSRs who are bank employees may, in connection with exercising their suitability responsibilities (*see* Suitability section), sell customers an insured deposit product, as appropriate.

Bank Employees

Generally, bank employees may, where permitted by state law, perform ministerial and clerical functions related to investment product sales, including referring potential customers to the designated sales location or representative. They may assist

prospective customers in completing account applications and forwarding paperwork to the DSR. Informational brochures or materials may be distributed to potential customers. Other examples of these clerical and ministerial functions include the following:

> Employees may assist customers interested in nondeposit investment products in completing a customer profile application that contains questions about customer income, investment goals, and existing account relationship(s) with the institution.
>
> Employees may complete profiles using a computer software program. Such programs may consider the customer's investment in insured products as well as nondeposit investment products.

Savings associations are cautioned, however, to review a recent SEC no-action letter on this issue. *INVEST Financial Corp., August 27, 1993.*

Identification of Personnel

Name Tags

If it is customary for bank personnel to wear name tags, the name tag of the DSR should also indicate the sales representative's title, such as "investment specialist," "investment counselor," or "investment representative."

Business Cards

Dual employees should have business cards, identifying them as bank employees and as employees of the broker-dealer, if applicable.

Customer Information

Customer information—such as name, address, telephone number, and types of products (including certificates of deposits) purchased—may be used by DSRs to determine potential prospects for nondeposit investment products. Other customer information may be used with appropriate notice and customer opportunity to object to disclosure of such information. Banks are cautioned to consult applicable state and federal requirements.

Product Name

A nondeposit investment product should not have a name that is identical to the bank's name (unless, of course, the securities of the bank, its affiliates, or its parent are being sold). Banks should take steps, such as enhanced training, to minimize possible customer confusion when a nondeposit investment product has a brand name similar to the bank's name or when the generic names of insured and uninsured products are similar (for example, money market mutual funds and money market deposit accounts). The relationship, if any, between a bank and a nondeposit investment product with a name similar to the bank's should be disclosed in appropriate advertising and marketing materials.

DISCLOSURES; ADVERTISING AND MARKETING

General

To ensure that customers are not confused about the uninsured nature of nondeposit investment products and are informed about the investment risks associated with such products, customers must be given adequate disclosures. Under certain circumstances (for example, sale of a bank's own securities), disclosures may have to be modified as appropriate.

Advertising and Marketing Disclosures

Advertising and promotional materials must be accurate and not misleading. Advertising and promotional, marketing, and sales materials given to customers should contain conspicuous and prominent notice that the product—

- is not a bank deposit,
- is not an obligation of, or guaranteed by, any bank,
- is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and
- involves investment risk, including the possible loss of principal.

In order to be conspicuous and prominent, the disclosures should be appropriately placed and in appropriate style and size of type so that the disclosures will not escape the customer's attention. For example, disclosures are not conspicuous and prominent if they are lost in the middle of a multi-page document or if they are in a typeface that is too small relative to the other typefaces used in the document.

Joint advertising or marketing of deposit and nondeposit investments should clearly distinguish FDIC-insured products from nondeposit investment products. Bank stationery (with the logo "Member FDIC") may be used, unless prohibited by state law, to send letters to customers regarding nondeposit investment products as long as the disclosures regarding the nondeposit, uninsured nature of the investments are included in the letter. At the same time, legends referring to "each depositor insured to $100,000" should not appear in letters to customers regarding uninsured investment products.

Before engaging in any joint advertising or marketing efforts, savings associations are cautioned to review a recent SEC no-action letter on the issue. *INVEST Financial Corp., August 27, 1993.*

"Advertising" means material published or designed for use in a newspaper, magazine, or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, telephone directories (other then routine listings), or other public media. Under certain circumstances (for example, broadcast media), shortened disclosures may be appropriate. These disclosures must nevertheless be conspicuous and prominent to fit the facts and circumstances.

"Promotional, marketing and sales materials" means any written communication distributed or made generally available to customers or the public, including circulars, pamphlets, brochures, form letters, excerpts or reprints of advertisements, or other sales literature.

Oral Sales Presentations

Oral sales presentations should also include the previously listed disclosures.

Written Disclosures

At the time of investment account opening or initial purchase of a nondeposit investment product, customers should be informed in writing that nondeposit investment products—

- are not bank deposits,
- are not obligations of, or guaranteed by, any bank,
- are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and
- involve investment risk, including the possible loss of principal.

Acknowledgment Form

At the time of investment account opening or initial purchase of an uninsured product, banks should ask the customer to sign a written acknowledgment form stating that the customer has read and understands the written disclosures and any sales charges or other applicable fees or charges. A sample form of written acknowledgment is presented on page 17.

Sales Confirmations and Periodic Account Statements

When sales confirmations or periodic account statements are issued by the bank (particularly periodic account statements that include information on both insured and uninsured products), they should also contain the previously listed disclosures. Periodic account statements should clearly distinguish information regarding FDIC-insured products from information on nondeposit investment products.

Prospectuses

Prospectuses should be provided to customers as required by securities regulations. As required by the SEC, prospectuses on mutual funds sold by or through the bank must disclose prominently on the cover of the prospectuses that shares of the fund—

- are not bank deposits,
- are not obligations of, or guaranteed or endorsed by, any bank, and
- are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other government agency.

In addition, disclosure regarding investment risk, including the possible loss of principal, should be provided to customers prior to, or concurrent with, prospectus delivery.

Continuing Disclosure Obligation

DSRs are reminded that the NASD has suggested that its members readvise their customers annually that, among other things, mutual fund shares purchased through banks are not deposits and are not FDIC-insured. *NASD Notice to Members, 93-87, December 1993.*

Bank as Adviser to a Mutual Fund

If the bank or a bank affiliate is an adviser to the mutual fund, the bank should orally disclose to the customer the nature of the advisory relationship. A bank that sells shares of a mutual fund advised by the bank or an affiliate should disclose in writing to the customer that—

- the bank or an affiliate acts as an adviser to the mutual fund,

- the bank or affiliate receives compensation from the mutual fund for the advisory services, and
- although the mutual fund is advised by the bank or an affiliate, investments in the mutual fund are not obligations of, or guaranteed by, the bank.

The existence of other material relationships between the bank or an affiliate and the mutual fund should also be disclosed in writing. These written disclosures may be satisfied through mutual fund prospectus delivery.

Annuities

Banks that underwrite annuities should disclose that relationship to the customer.

ADVERTISING AND MARKETING CONSIDERATIONS

Determine Who Is Doing the Speaking

In constructing an advertising and marketing campaign, it is essential that the campaign be focused on who (for example, the bank, the broker-dealer, or the mutual fund) is offering the product and service that is being advertised or marketed.

A bank can advertise and promote the services that it can lawfully offer its customers.

> For example, a bank may state in its advertisements that: "We make available to our customers XYZ family of mutual funds," "Our bank is pleased to have been selected to serve as the investment adviser to the bank's proprietary fund," or "Our bank investment specialists are trained to help you, the consumer, select the types of securities that will help you achieve your investment goals."

A bank cannot speak for the mutual fund, as the mutual fund has a separate corporate identity. Moreover, the mutual fund's shares are not bank products. The bank product, if any, is investment advice being offered to the bank's proprietary or private label registered fund.

> For example, a bank ad should not say: "**Our** mutual fund is highly suitable for your long-term investment needs" or "**We** are pleased to announce the launch of our mutual fund."

Bank ads may promote a financial supermarket theme.

> For example, bank ads can stress the abilities of the bank's investment specialists, a particular investment style, or some specific service or technology that the bank can offer.

77-127 O - 94 - 8

Mutual fund and broker-dealer advertisements may describe the benefits of investing with their firm. Those advertisements are, however, subject to further regulation as outlined below.

> A mutual fund or a broker-dealer must follow rules of the SEC with regard to its advertisements and have its advertisements reviewed by the NASD. Appropriate attention by the fund or the broker-dealer must also be given to recent bank regulatory guidance with respect to retail sales of nondeposit investment products through banks.
>
> Mutual fund and broker-dealer advertisements are subject to the antifraud provisions of the federal securities laws. *See* Rule 156 under the Securities Act of 1933, 17 CFR 230.156; Rule 10b-5 under the Securities Exchange Act of 1934, 17 CFR 240.10b-5.
>
> Under the federal securities laws, advertisements that offer any security for sale are deemed to be prospectuses. Section 5 of the Securities Act of 1933 prohibits the use of a prospectus to offer or sell a security unless a registration statement is in effect and the prospectus meets the requirements of Section 10 of the Securities Act. In order to comply with the prospectus delivery requirements of Section 5, a mutual fund advertisement must comply with either Rule 134 or Rule 482 under the Securities Act, 17 CFR 230.134 or 482, or be treated as sales literature and accompanied or preceded by a statutory prospectus.
>
> Section 35 of the NASD's Rules of Fair Practice require members to file mutual fund advertisements with the NASD within 10 days of first use or publication. Filing in advance of use is highly recommended. Ordinarily, the fund's distributor is responsible for filing.

It is recommended that any advertising and promotional materials used by the bank be reviewed by bank management or counsel or, where appropriate, counsel to the mutual fund or broker-dealer.

SAMPLE INVESTMENT PRODUCT ACKNOWLEDGMENT

By my signature below, I acknowledge that I have read and understand the following features of my investment that have been checked by the Designated Sales Representative as applicable:

- ☐ The investment products I am purchasing are not bank deposits and are not obligations of, or guaranteed by, any bank. These products are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.
- ☐ Where appropriate (for example, mutual funds and equities), I have received a current prospectus and understand the sales charges and other applicable fees or charges as disclosed in the prospectus.
- ☐ Sales charges and other applicable fees or charges regarding other investment products purchased have been disclosed.
- ☐ I understand that the investment products purchased are subject to investment risk, including possible loss of principal.
- ☐ Although payment of principal (at maturity) and interest on securities in U.S. government funds is guaranteed to the fund, the market value of the shares will fluctuate with rising or declining interest rates.
- ☐ An investment product's past performance should not be considered an indication of future results.
- ☐ Procedures for redeeming, surrendering or selling my investment may vary, depending on the investment selected, and have been disclosed.
- ☐ The investment products I am purchasing ARE/ARE NOT insured by the Securities Investors Protection Corporation ("SIPC"). SIPC coverage is not the same as the federal deposit insurance provided by the FDIC. It does not protect investors against a decline in the market value of securities. SIPC generally protects customers against the *physical loss* of securities if the broker/dealer *holding* the securities for the customer fails.

Name(s) as shown on account ______________________________

Account # ______________ Amount of initial investment ______________

Investing in ______________________________

Signed ______________________ Signed ______________________

Date ______________

Recommended: Form to be in Triplicate (Copies to Accountholder, Branch Office, and Central Office)

SUITABILITY

Applicability to Registered Representatives

Registered broker-dealers should refer to the NASD's Rules of Fair Practice when drafting their own suitability compliance program. The following discussion on suitability is intended to assist those persons not governed by the NASD's Rules of Fair Practice.

General

Suitability as used in the financial context refers to the appropriateness of a particular investment, type of investment, or portfolio of investments to an investor, given the investor's unique circumstances.

Suitability encompasses not only suitability as it relates to the customer but also as it relates to investment products offered. A helpful suitability checklist would include consideration of—

- adoption of appropriate suitability guidelines;
- using appropriate product feature aids—brochures, charts, and so forth;
- requiring appropriate staff training; and
- conducting effective trade review (*see* Bank Management and Board of Directors Oversight section).

DSRs involved with the offer and/or sale of securities have an obligation of fair dealing under the general antifraud provisions of the federal securities laws and shall observe high standards of commercial honor and just and equitable principles of trade.

A suitability standard consistent with the NASD's Rules of Fair Practice should apply in all cases where investment advice is offered to bank customers. That advice may be provided only by trained and knowledgeable staff.

Suitable Recommendations to Customers

In recommending to a customer the purchase, sale, or exchange of any nondeposit investment product, a DSR should have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his or her other security holdings and as to his or her financial situation and needs.

"Know Your Customer"— Obtaining Customer Information

Prior to the execution of a transaction recommended to a retail customer, other than transactions where nondeposit investments are limited to money market mutual funds, a DSR shall make reasonable efforts to obtain information concerning the customer's financial background, tax status, personal and financial situation, investment objectives, tolerance for risk, and any other similar information concerning the customer.

- The existence of sales and redemption charges on mutual fund products may make material differences in the return on the investment under certain circumstances. A DSR should consider these and other similar features in assessing bank customers' goals and objectives.

Risk Diversification

Where appropriate, DSRs should consider risk diversification in making recommendations to customers.

Unsolicited Transactions

Unsolicited transactions may be executed on behalf of a customer, without regard to suitability, if so directed by the customer. A DSR may wish to consider the type of documentation necessary (for example, trade ticket, confirmation, etc.) to substantiate the trade as unsolicited.

For customers seeking discount brokerage service (that is, order execution only; no recommendation), transactions may be executed, without regard to suitability. A DSR may wish to consider the type of documentation necessary (for example, trade ticket, confirmation, etc.) to substantiate the trade as unsolicited.

Recordkeeping

A record for each account shall be maintained containing the following information:

- customer's name and residence;
- whether the customer is of legal age; and
- signature of the DSR and his or her supervisory person.

For all retail accounts, other than accounts limited to transactions in money market funds, DSRs shall make reasonable efforts to obtain, prior to settlement of the initial transaction in the account, the following information:

- tax identification or Social Security number;
- customer's occupation;
- name and address of employer; and
- information concerning the customer's financial background, tax status, personal and financial situation, investment objectives, tolerance for risk, and any other similar information concerning the customer.

Suitability Is *Not*

The following practices are inconsistent with the principle of suitability:

- trading in mutual fund shares, other than money market mutual funds, on a short-term basis;
- recommending the purchase of securities or the continuing purchase of securities in amounts that are inconsistent with the reasonable expectation that the customer has the financial ability to meet such ongoing financial commitment;
- guaranteeing a customer against loss in any securities transaction effected by the bank with or for such customer.
- recommending speculative low-priced securities to customers without knowledge of or an attempt to obtain information concerning the customers' other securities holdings, their financial situation, and other necessary data.

EMPLOYEE QUALIFICATIONS AND TRAINING

General

Bank management, DSRs, and audit and compliance personnel involved with the bank's investment product program should demonstrate competence appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures.

Background Checks

Background checks for all new DSRs who will be engaged in the offering and/or sale of nondeposit investment products are strongly recommended. Reviews of new employees with previous securities or insurance industry experience should include a check with appropriate authorities for possible prior disciplinary actions.

Licensing and/or Certification

When appropriate and possible, DSRs should obtain an appropriate NASD license, such as a Series 6 or 7. A NASD license equivalency certificate may also be appropriate.

Audit and Compliance Personnel

Employees responsible for compliance and/or auditing the bank's investment program should be competent and knowledgeable regarding the federal and state regulatory requirements for such programs.

Training

Industry trade groups should assist their members in obtaining appropriate training.

Bank management, DSRs, audit and compliance personnel involved with the bank's investment product program, and other bank employees should be offered training appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures.

Training should cover product knowledge, operational concerns, sales and advertising practices, compliance and regulatory issues, disclosure, and suitability and ethical considerations.

Continuing Education

Continuing education requirements ultimately adopted by the securities and insurance industries should also be adopted and modified, as necessary, by the banking industry.

EMPLOYEE COMPENSATION AND REFERRAL FEES

Bank Policy

A bank should have written policies governing the commissions, referral fees, and other compensation that the bank, its DSRs, and nonsales employees receive on the sales of nondeposit investment products.

Employee Compensation

Suitability, not compensation, should guide sales of nondeposit investment products. Banks are urged to cultivate a customer-oriented sales ethic: "If it's good for the customer, it's good for the bank."

Compensation of DSRs

Compensation for the sale of nondeposit investment products should be structured to avoid incenting the sale of unsuitable products.

DSRs should be free to offer customers a choice of investment products that provide different levels and types of compensation. For example, compensation may be commensurate with the amount invested, the duration of the investment, and the income generated to the bank by the investment. However, DSRs should not favor or disfavor the sale of a particular investment company, group of investment companies, or insurance company product based solely on the receipt of brokerage commissions or other incentives.

Referral Fees

Fees based on referrals may be structured so as to encourage tellers and other bank employees to appropriately increase customer awareness of the availability of all types of nondeposit investment products offered by their institutions.

Compensation to tellers and other bank employees for a referral should not be based on the success of the referral in generating a sale of a nondeposit product(s).

Tellers and other bank employees may be compensated based on individual or total referrals that result in customer meetings with DSRs.

BANK MANAGEMENT AND BOARD OF DIRECTORS OVERSIGHT

Overall Policy

A bank should establish and maintain written policies and procedures regarding retail sales of nondeposit investment products. Such policies and procedures should encompass third-party and affiliated vendor sales, sales of proprietary products, and sales of both third-party and proprietary products by bank personnel, as applicable.

Board of Directors ("Board") Responsibilities

Under the bank's policies and procedures, the Board should be responsible for—

- evaluating the risks posed by programs that offer nondeposit investment products (for example, loss of customers if products not offered; associated risks, if any, to insured bank's reputation posed by downturn in the securities markets; and capacity of bank to manage these and other risks);
- approving written policies and procedures; and
- delegating responsibility to bank management concerning retail sales of nondeposit investment products.

In determining bank management responsibilities, the Board may choose to retain for itself any of the responsibilities listed below, such as entering into third-party vendor agreements.

Bank Management Responsibilities

Bank management should establish, maintain, and enforce a system to manage its retail investment activities and those DSRs involved with offering nondeposit investment products to the retail public. Such a system should be reasonably designed to achieve compliance with applicable banking, securities, and insurance laws and regulations. Final responsibility for proper oversight should rest with bank management.

Oversight Program

At a minimum, an oversight program should be in writing and address the following:

Investment Product Selection.

- Specify what types of investment products the bank will sell and offer investment advice with regard thereto, and what policies and procedures will govern the selection and marketing of products. Such policy should include qualitative considerations, such as ratings by nationally recognized statistical rating organizations, investment philosophy supporting the product, and financial condition and stability of the investment product and its provider.

  For example, a bank may wish to specify whether and under what circumstances and capacity (for example, bank or through broker-dealer) it will accept orders for equities and corporate debt securities and make available investments in commercial paper, U.S. government securities, municipal securities, repurchase agreements, and banker's acceptances.

- Make available a suitable array of investment products to bank customers.

  For example, those banks offering mutual funds to customers should offer a variety of choices, that is, funds whose investment objectives vary.

Allocation of Responsibilities Among Parties.

- Outline responsibility for each activity or function specified in the sales policy and specifically assign responsibility for such activity or function to an individual employed by the bank, a third-party vendor, or an affiliated broker-dealer, including:

  —designating supervisory person(s) to supervise, review, and endorse transactions in accounts handled by DSRs and to specifically approve the opening of new customer accounts;

  In this connection, supervisory person(s) should maintain a customer account file that includes all written and verbal complaints, if any, and should adequately investigate such complaints.

—designating supervisory person(s) to review sales literature, advertisements, radio and television presentations, seminar presentations, and outgoing correspondence regarding retail sales of investment products.

- Require participation of each DSR, either individually or collectively, no less than annually, in an interview or meeting conducted by appropriately qualified persons at which compliance matters relevant to the activities of the DSR(s) are discussed.

Customer Information.

- Specify bank's policies governing the permissible uses of bank customer information in connection with the marketing and sale of investment products.

Vendor Agreements

Bank management should be responsible for entering into governing agreements with third-party vendors and affiliated broker-dealers. Such agreements should clearly outline the duties and responsibilities of all parties, including the responsibility of third-party vendors and affiliated broker-dealers, to—

- issue appropriate disclosures to retail customers,
- comply with appropriate suitability standards,
- establish appropriate compensation programs,
- perform background checks on and train appropriate personnel,
- monitor compliance with applicable law, and
- maintain appropriate account records regarding the sale of nondeposit investment products sold through the bank.

In addition, such agreement should include provisions regarding bank oversight of all bank-related retail sales by such party, as well as examiner access to appropriate records.

Bank-Affiliated Mutual Funds

Bank management should be responsible for taking appropriate precautions regarding bank-related retail sales of bank- or bank affiliate-advised mutual funds. Such precautions should include orally disclosing to the customer the nature of the advisory relationship and disclosing in writing that—

- the bank or an affiliate acts as an adviser to the mutual fund;
- the bank or affiliate receives compensation from the mutual fund for the advisory services, and
- although the mutual fund is advised by the bank or an affiliate, investments in the mutual fund are not obligations of, or guaranteed by, the bank.

The existence of other material relationships between the bank or an affiliate and the mutual fund should also be disclosed in writing. These written disclosures may be satisfied through mutual fund prospectus delivery.

Insurance Coverage

Prior to embarking on a sales program for nondeposit investment products, bank management should notify their blanket bond carriers of their plans to engage in these activities. Written assurance should be obtained that staff representing third-party and affiliated vendors have appropriate insurance coverage.

Compliance Program

A compliance program, independent of investment product sales and management, should be established. The program should be capable of verifying compliance with banking, securities, and insurance laws and regulations. The compliance function should also include a system to monitor customer complaints and to review periodically customer accounts, including spot checking, to detect and prevent abusive practices. Appropriate corrective actions should be implemented when necessary.

As part of a compliance program, a bank may wish to consider establishing a targeted call back program, a mystery shopper program, or some other method of monitoring compliance with the bank's policies and procedures. A targeted call back program could be designed to call certain customers shortly after they have opened an investment account with the bank to determine if the bank's policies and procedures were satisfied.

A bank may wish to consider building into its procedures for opening customer accounts an agreement between the customer and the bank to submit any disputes that arise to arbitration. A sample arbitration agreement is presented on page 35.

Insider Trading

To avoid liability under the federal insider trading laws, banks should establish policies and procedures to prevent insider trading. (Broker-dealers are required to have policies and procedures.) Insider trading refers to the purchase or sale of securities while in possession of material, nonpublic information that would be important to an investor in making a decision whether to purchase or sell securities. The federal securities laws impose liability on employers, including banks, as well as their officers, directors, and supervisory personnel for illegal insider trading activities of their employees.

Liability can result in civil fines of $1 million or three times the profits gained or losses avoided, whichever is greater. Criminal penalties for insider trading violations can also result, which may include maximum monetary penalties of $2.5 million. Thus, if a bank employs an individual who trades on inside information, the bank and its directors, as controlling persons, may be liable for civil and criminal penalties in excess of $3.5 million. In addition, jail terms of ten years can result.

Liability can also result when an employee commits tipping violations. Specifically, a bank may be liable even if an employee does not trade on inside information but communicates such information to another individual who trades on the basis of that information.

ARBITRATION

Banks may wish to resolve any disputes with customers involving securities transactions through arbitration. Arbitration is a dispute resolution mechanism whereby the parties to the dispute set forth their positions before either a single arbitrator or a panel of arbitrators, who then render a decision. That decision is binding on the parties. Generally arbitration is faster and less expensive than litigation.

The securities industry uses arbitration extensively. The NASD, the NYSE, the American Stock Exchange ("AMEX") and the Municipal Securities Rulemaking Board ("MSRB") all have established rules and procedures for securities arbitration. Banks using registered broker-dealers, either affiliated or unaffiliated, to sell securities through the bank to the retail public would generally use the rules and procedures of one of these organizations. For banks not using registered representatives to sell securities to the retail public, the rules and procedures of the American Arbitration Association ("AAA") are available.

Arbitration is voluntary, so both the bank and the customer must agree to arbitrate. That agreement can be obtained either before or after any dispute arises. A sample agreement to arbitrate is presented on page 35. If a bank wishes to obtain the agreement pre-dispute, it should be obtained at the time the customer account opening forms are signed. An arbitration provision may be incorporated into the account opening agreement. It should be noted, however, that the securities industry generally uses pre-dispute arbitration agreements for margin and options accounts.

Finally, while arbitration is less expensive than litigation, it does involve some expenditure of funds. Each organization has its own fee structure and should be consulted.

For more information, contact the Director of Arbitration at one of the following organizations:

American Arbitration Association
140 West 51st Street
New York, New York 10020
212/484-4000

American Stock Exchange, Inc.
86 Trinity Place
New York, NY 10006
212/306-1000

Municipal Securities Rulemaking Board
1818 N Street, N.W.
Washington, DC 20036
202/223-9347

National Association of Securities Dealers, Inc.
33 Whitehall Street
New York, NY 10004
212/858-4400

New York Stock Exchange, Inc.
11 Wall Street
New York, NY 10005
212/656-2772

SAMPLE AGREEMENT TO ARBITRATE

I/we understand and acknowledge that:

- Arbitration is final and binding on the parties.
- __________ (The name of the Bank or Broker offering investment services) and I/we are waiving our right to seek remedies in court, including the right to a jury trial.
- Pre-arbitration discovery is generally more limited than and different from court proceedings.
- The arbitrators' award is not required to include factual findings or legal reasoning, and any party's right to appeal to a court of law or to seek modification of rulings by the arbitrators is strictly limited.
- The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

I/we hereby agree that all controversies which may arise between us, including but not limited to those involving any transaction or the construction, performance, or breach of this or any other agreement between us, including the Investment Product Acknowledgment, whether entered into prior to, on, or subsequent to the date hereof, shall be determined by arbitration. Any arbitration under this Agreement shall be conducted only before ______________________ * and in accordance with its securities arbitration rules then in force. Judgment upon the award of the arbitrators may be entered in any court, state or federal, having jurisdiction.

By signing this Agreement below, I/we hereby consent and agree to the terms and conditions set forth herein.

Customer's Name ______________________________________

Customer's Signature ______________________________________

Co-Owner's Name (if applicable) ______________________________

Co-Owner's Signature (if applicable) ____________________________

Bank or Broker name ______________________________________

by Designated Sales Representative ___________________________

Date ____________________

*The National Association of Securities Dealers ("NASD") and the Stock Exchanges, e.g., New York Stock Exchange ("NYSE"), have established arbitration procedures and agreements for registered brokers. By and large, this sample agreement envisions using the procedures and forms of the NASD, NYSE, etc., if a registered broker-dealer is conducting the sale on bank premises. If, however, a qualified bank employee, not a registered broker-dealer, conducts the sale, the procedures and forms of the American Arbitration Association are available. Contact your local AAA office or national AAA headquarters (140 West 51st Street, New York, NY 10020-1203) for guidelines and procedures.

CONSIDERATIONS FOR SELECTING THIRD-PARTY PROVIDERS AND INVESTMENT PRODUCTS

While not exhaustive, the following factors are important and should be taken into account when a bank undertakes to choose a product or service provider.

Financial Strength Standards

The financial health of product and service providers is of fundamental importance to investors. Therefore, the bank should evaluate the financial strength of such providers to determine whether they will be able to meet their financial commitments.

Adequacy of Regulatory Oversight

Third parties are subject to the regulatory oversight of both national and state agencies. Therefore, the bank should initially and periodically review the record of regulatory compliance by both the provider corporation and its sales representatives.

Ongoing Commitment to the Product

A bank should review the third-party and/or product provider's capacity and willingness to maintain its commitment to the business and to the product.

Clear Product Features/Pricing

The products to be sold should be competitive with other similar products; terms and conditions should be clear and easy to understand.

Consumer Disclosures and Protection

The third-party provider should adhere to these guidelines in all aspects. Consistent with these guidelines, the third-party provider should incorporate disclosures into the sales process, adopt procedures so that the right products are sold to the right customers, and have established an appropriate compliance program.

Consistent Implementation Oversight

Implementation activities by the third-party provider should be consistent with and support the bank's overall goals and objectives, its ethical standards, and its corporate and investment product strategies.

Review

A review should be conducted initially by the bank before offering an investment product and periodically while the product is being offered to bank customers. Similarly, a review should be conducted initially by the bank before entering into an agreement with a third-party provider and, periodically, during the length of the contractual relationship.

Minneapolis Star Tribune
January 2, 1994

Editors note: On the Money's eager Mr. Pigeon starts the new year by venturing into high finance in pursuit of building a college fund for his two little chicks. He opted to try out how Twin Cities banks are doing as they enter into the business of selling mutual funds — a new trend for those financial institutions. Mr. Pigeon's tales on adventures in consumerism appears the first Sunday of each month.

• • • • •

By Mr. Pigeon
Staff Writer

Mr. Pigeon paused from his holiday gorging, shopping and exchanging long enough to think, "Is there something better I could be doing with my money?"

With two young chicks in the nest, the Pigeon figured that maybe he should spend less on noontime lunches, rental videos and compact discs. Instead, he should start building a bigger nest egg for his kids.

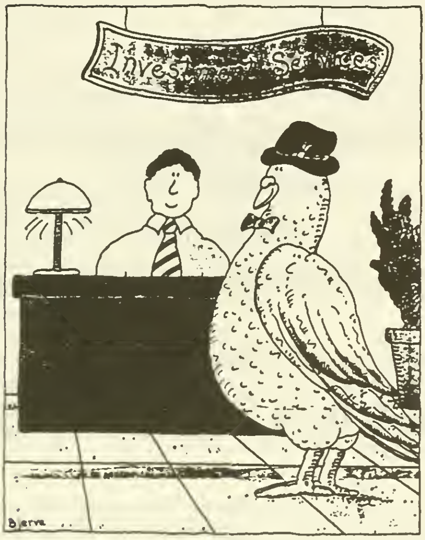
But what kinds of investments — other than Powerball, Daily 3 and greyhound racing — could a regular bird like the Pigeon afford? Then he read an article about mutual funds — those portfolios of stocks and bonds organized and managed by finance professionals that allow people without the capital of Curt Carlson or Prince to participate in potentially more lucrative investments.

And Mr. Pigeon also read how more banks are getting into the business of selling mutual funds.

He did hear some bad news. Some banks are aggressively pushing riskier mutual funds on resource-strapped seniors while others have been lax in meeting their legal obligation to warn folks that mutual funds are not insured by the Federal Deposit Insurance Corporation (FDIC).

In fact, according to Mr. Pigeon's wise friend Mr. Hawk, a recent survey of the Securities and Exchange Commission showed that 28 percent of investors believed that all mutual funds sold through banks were covered by deposit insurance. And 30 percent of those surveyed believed that mutual funds sold by banks were safer than other mutual funds. They're not.

Still, the Pigeon was interested. And he wanted to know more. So he decided to plop down on local offices of Norwest, First Bank, TCF and Firstar banks to get the poop on mutual funds. This is his tale.



TCF Bank

The Pigeon called the Apple Valley branch office to ask whether mutual funds could be bought there. Terry Smith, branch manager and broker/dealer said, "Sure."

So, without making an appointment, Mr. Pigeon dropped by that afternoon. After a couple of minutes of waiting, Smith walked over and invited the Pigeon to her TCF Securities cubicle. "When I step in here, I'm not an employee of the bank but of TCF Securities," Smith said. She also quickly pointed out that the products TCF Securities sells are not FDIC insured.

Smith was nice. Very down to earth. And very cautionary. She repeatedly mentioned that mutual funds carry risk. And she suggested several fund options that carried less risk than others — such as those that deal primarily with government bonds and utility companies and riskier, albeit potentially more rewarding, funds that aggressively buy stocks in high-tech companies, health care organizations and financial firms.

"If you are willing to take the risk, the return can be much better," Smith said of the growth funds.

For example. A more conservative income fund showed a return of 5.56 percent over the past year. Another, more aggressive fund, showed a year's earnings of 28.28 percent. The risk of losing the money you put into those funds is higher if the market turns down, she said.

She said the Pigeon could get in on mutual funds for as little as $25 a month — deducted right from his checking account. Other funds require higher minimum investments to start, she said. She explained that fees are collected from the money invested. Of the $25 a month, for example, $23 and change would be invested while the rest would go to the investment firm as a fee.

She gave the Pigeon copies of fund prospectuses, offered by Putnam Investments, and explained that TCF has been in the mutual fund business for only two months. The bank got into funds for competitive reasons, she said.

"Money was going out our door. We couldn't afford not to."

Firstar

One of the things the Pigeon wanted to find out was whether he could just walk into a bank without an appointment and find out something about mutual funds. Apparently, Firstar isn't the place to go on the spur of the moment.

He called Firstar's Bloomington branch on a Monday morning, was transferred from the receptionist to a broker's line and, then, to voice mail.

Mr. Pigeon left the message that he might stop by about 1:30 p.m. that day. That afternoon, when he dropped by the bank, he waited for 15 minutes before another banker came over to tell him that all the investment brokers were out of the office. She called a couple of other branches to find out if any investment brokers were available. No luck.

The Pigeon left his phone number and a time he would stop by the next day.

When he returned, the investment banker was not there. The receptionist told Mr. Pigeon that he had left a message that they could not meet. Could Mr. Pigeon leave his phone number and set up an appointment? The Pigeon decided to leave.

Two other Firstar branches, same result. At the Firstar bank in downtown Minneapolis, Mr. Pigeon was told, "Our investment people are at other branches today." A receptionist gave him two telephone numbers "to try." At the Firstar in downtown St. Paul, a banker gave him the telephone number of a guy in the Roseville branch. The Pigeon gave up.

Later, Firstar broker Mike O'Brien explained that Mr. Pigeon's difficulties are not the norm. Firstar has seven brokers to cover 26 metro-area offices, but demand for those services has not been high at all branches. Now, he said, business is booming and brokers have been spread thin.

First Bank

At the downtown Minneapolis First Bank, it took about two minutes from the time Mr. Pigeon asked a receptionist for mutual fund help until Anita Hawks came over, smiled, shook his hand and walked him to her desk in the investments area.

Mr. Pigeon told Hawks that he wanted to find something that could help pay for college for his young children, something with a little better return than savings accounts. He asked her to tell him more about mutual funds.

Hawks appeared knowledgeable, polished and genuinely warm. "Do you want the long version, the short version or the in-between?"

Mr. Pigeon asked for the in-between.

She immediately laid out pamphlets, fliers, brochures, prospectuses and other materials. And she immediately warned Mr. Pigeon that mutual funds are not FDIC-insured. She did not, however, seem too worried about the risks.

Because of the diversity of corporations represented in many funds, she said, mutual funds can ride out stock market crises better than individual stocks. "It's not very likely that 85 companies in one fund will all go under at the same time," she said.

And there are a variety of funds and families of funds that range from the more conservative to the more speculative. Again, though, she was totally confident in the safety of mutual funds and mentioned nothing about drawbacks or risks. Hawks characterized the more conservative investments as something "a 90-year-old may want" because of their concern with options that provide a stable source of income.

She focused on a few funds that First Bank provides — called First American Funds — because those are the ones she works with most often. But she pointed out stacks and stacks of literature on other mutual funds such as Putnam and Fidelity.

If you are concerned about stability, she suggested investing in a variety of funds that range from conservative to aggressive. Mr. Pigeon asked Hawks what she invested in.

A little of everything, she said. Annuities, mutual funds, bonds and the stock market. Her father got her started in the ways of the market, she said.

"I'm comfortable with stocks," Hawks said. "I've made money in stocks."

Finally, the Pigeon said, "I'm a worrier. You've talked about all the advantages to mutual funds. What's the down side?"

Hawks has a very nice smile. "You could lose a little principal," she said.

She offered to help Mr. Pigeon set up a fund anytime. She said he would need a minimum of $1,000 to start a mutual fund and she said she knew of no other funds in which he could start for less. After the minimum payment, she said, he could pay as little as $100 a month into the fund.

No pressure. Lots of information — although not much about risk. Friendly. And the required no-FDIC disclosure. Overall, a pretty comfortable and informative visit.

Norwest

Bradley Wendel, senior vice president and sales manager for Norwest Investment Services at Norwest Center in downtown Minneapolis, didn't resort to bells and whistles to tell Mr. Pigeon about investment options.

He used a ballpoint pen, easy-going explanations and some creative doodling. And it worked.

After the Pigeon told Wendel about his two kids and asked about mutual funds, Wendel quickly jotted down some illustrations showing how a balance of conservative investments in treasury bonds and regular monthly investments in stock mutual funds could be a solid combination.

The bonds, Wendel said, would provide guaranteed income that could be structured to become available just as the Pigeon's 2-year-old needed cash to buy college books or make a dormitory deposit. The Pigeon could buy the bonds in $1,000 increments for half their maturity value — for example, a $1,000 zero-coupon bond that matures in 15 years for $500 now.

"That's a good option for gift money your kids get from grandparents, Christmases, things like that," Wendel said, adding that he is buying bonds at staggered times so they mature throughout his three young sons' college years.

With monthly contributions to mutual funds — more aggressive early on and more conservative as the kids get closer to college age — Mr. Pigeon could earn a heftier return that kept ahead of inflation.

Wendel, who spent more than a half-hour with Mr. Pigeon with no appointment, said there would be no minimum payment to get into mutual funds and it could be set up with a checking deposit slip or canceled check. By making regular monthly purchases, Wendel said, a mutual fund takes advantage of those times when stock prices are lower to buy more stock. It's called "cost averaging," he said. And if investors are willing to ride out the peaks and valleys of the market over the years, it can pay off.

Caution. Wendel preceded many of his platitudes of mutual funds and their returns with a string of "probably, usually, occasionally, maybe." "It's a soft way of telling you there are risks," he said. And, no, he volunteered, neither mutual funds nor treasury bonds are FDIC-insured.

Many mutual funds require no minimum payment, Wendel said. And monthly contributions can range from $50 to $100. Some funds require no management or brokers fees, if the stockholder keeps his money in for at least six years.

Wendel offered to meet with Mr. Pigeon and Mrs. Pigeon to go into further detail. With his low-pressure, easy-to-follow approach, Mr. Pigeon thought he would probably be calling Wendel soon. After all, those chicks aren't getting any younger. And Mr. Pigeon certainly isn't getting any wealthier.

CALL MR. PIGEON

Mr. Pigeon would like to hear about those consumer experiences that have left you confused or angry, as well as those that have given you a warm glow of consumer satisfaction. If you'd like to share your tips with the Pigeon, please call his voice mail line at 673-9078 and leave a detailed message. He won't solve your problems — but he might be able to let other consumers learn from your experiences.

TESTIMONY

of

JOHN SHIVERS

CHAIRMAN/PRESIDENT/CHIEF EXECUTIVE OFFICER
SOUTHWEST BANK
FORT WORTH, TEXAS

on behalf of the

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

of the

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 8, 1994

Mr. Chairman, I am John Shivers, Chairman, President, and CEO of the Southwest Bank in Fort Worth, Texas. I am also President of the Independent Bankers Association of America (IBAA). The IBAA is the only national trade association that exclusively represents the interests of community banks.

We appreciate this opportunity to discuss the involvement of banks in mutual fund sales and the actions banks are taking to assure that our customers understand the risks they take when they buy a mutual fund from a bank. We know that it is very important that banks do this right. Investor and depositor protection is of paramount concern.

To a large extent community banks offer mutual funds for defensive reasons; many of our customers are demanding alternative investment options. If community banks do not offer them, our depositors will take their purchase orders elsewhere. Remember, our customers' education levels have increased tremendously. Furthermore, they are aware that they can walk into a brokerage firm and have access to traditional banking services such as checking accounts, debit cards, and loans.

Community banks would much prefer that their customers keep their funds in core deposits that can be used to support local economies. Since this is not entirely possible, a growing number of community banks are offering a mix of deposit products as well as nondeposit investment products such as mutual funds so that they can maintain key customer relationships.

We are concerned that unnecessary restrictions on bank sales of mutual funds could effectively prohibit banks, particularly small banks, from selling mutual funds. This would ultimately hurt bank customers. We believe that all sellers of mutual funds, including community banks, can and should educate their customers about the risks involved in mutual funds. Banks can do this without being subject to additional laws and unworkable regulations. It is also in community banks' interest to point out the advantages of federally insured products, since deposits are the funding source community banks use for profitable lending to local consumers and small businesses.

Involvement of the Banking Industry

The large majority of community banks are not involved in mutual funds sales. The results of a soon-to-be-released survey by Grant Thornton confirm this statement. The survey of more than 1,000 community banks found that 81% of the responding banks currently do not sell mutual funds. The survey also found that the smaller the bank the less likely that the institution was selling mutual funds. When the banks that are currently not selling mutual funds were asked if they plan to begin selling mutual funds in 1994, only 7% answered "very likely," and another 8% indicated that it was "likely." This data (chart attached) supports our contention that community banks are entering the mutual fund business as a defensive move to meet customer demands.

To help those community banks that want to offer mutual funds to their customers and to do it "right," the IBAA Community Banking Network has just launched a mutual fund

program with MFS Financial Services Inc. MFS Financial Services is the sales company of Massachusetts Financial Services, America's oldest mutual fund organization. MFS manages more than $33 billion in assets for 1.6 million individuals and institutions. MFS will work through a new company, IBAA Financial Services Corporation (IBFS) to deliver mutual funds to community bank customers.

IBFS gives community banks the opportunity to use a uniquely consumer-friendly program, the Financial Asset Builder (FAB) to help their customers select the right investment product for them. FAB is a computerized, step-by-step financial planning program designed to help individuals meet their short- and long-term financial needs. After working through the program with a customer, the sales representative will be in a position to recommend the appropriate mix of federally insured and non-insured products. For example, the program offers well-established financial advice that a family should have at least 6 months of emergency funds available in insured deposits before investing long-term money in a non-insured product.

This is how the program works: A customer is given a workbook to gather information on his long- and short-term goals and priorities, current financial situation, and risk tolerance. This information is then entered into a computer program that outlines a financial plan the customer can use to meet his financial goals. A copy of the workbook is included with my testimony.

All sales and promotional literature that customers receive contains the following prominently boxed disclosure:

> **The investment products offered at your bank are not insured by the FDIC or any other government agency, and are not deposits of, obligations of, or guaranteed by, your bank. Shares of mutual funds are subject to risk, including possible loss of principal, and may fluctuate in value. You may receive more or less than you paid when you redeem your shares. Please see the prospectus for details.**

However, the important feature of the program is the Financial Asset Builder. A sales representative that uses this program will be in an excellent position to recommend suitable financial products. They may range from an insured savings account to build up emergency reserves to a stock mutual fund to provide for college education or retirement. The key is that these recommendations will be based on the customer's goals, current financial picture, and individual risk tolerance.

My own bank offers alternative investment products, including mutual funds, stocks, bonds, and annuities, through a third-party broker that leases space in the bank. We studied the marketplace for a full year before selecting our provider and consulted with two separate attorneys before putting the program in place.

Since its launch last year, our program has served over 80 clients, providing a full range of investment and financial planning services. It is interesting to note that most of the money placed in the program originated outside of the bank -- mainly from other brokerage firms. When questioned, our customers explained that they would rather consolidate all of their financial business in one place. We are pleased that the Southwest Bank has been able to offer this alternative.

Southwest Bank serves an area with many retirees from major Fort Worth companies. Because of the expertise in this area that our program representatives have, we are now able to offer state-of-the-art retirement planning services. This helps us to better serve our customer base in an area of critical importance to them while we create new business relationships.

While our third-party provider makes it absolutely clear that it, and not the bank, is providing investment services, it operates under the close scrutiny of bank management. A senior bank officer sits in an office next to the brokerage office and knows on a day-to-day basis how the representative is operating. That bank officer recently performed a full audit of the program and found our provider was operating in full accordance with the bank's agreement with them. We have not received one customer complaint since starting this service.

Each customer signs an acknowledgment making clear that brokerage services are not provided by the Southwest Bank. The acknowledgment also contains the following statements:

> **I, further acknowledge that none of the securities or insurance products which were recommended by or acquired through Investment Professionals, Inc., or its licensed representatives were in any way recommended or guaranteed by Southwest Bank, nor are such investments insured by the Bank's insurance under the Federal Deposit Insurance Corporation (FDIC). These products are not obligations of the Southwest Bank and involve investment risks, including the possible loss of some or all of the principal.**

I have attached to my testimony a document titled "Important Points Regarding the IPI Program" which further details how the program operates.

Action the Banking Industry is Taking to Provide Disclosure

The banking industry clearly recognizes the need to adequately disclose the fact that mutual funds are not federally insured. No bank wants to jeopardize a valued customer relationship. Disclosure is the key to assuring that customers know whether or not the product they are buying is federally insured. As the most trusted provider of financial services, banks will adopt full disclosure as the best, and the only, policy.

Community banks have a particularly strong interest in making these disclosures, since they know their customers and want to provide the best possible service. Late last year the IBAA provided a statement stuffer to our banks for their use in educating their customers and disclosing the facts about mutual funds. The document, a copy of which is attached to this testimony, says, in part, that:

> **Mutual funds are not federally-insured deposits. Mutual funds purchased at FDIC-insured banks are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or by any other government agency, nor are they guaranteed by the bank.**

Some 290 community banks have ordered 614,500 copies of these statements to distribute to their customers.

The IBAA also joined with 5 other banking trade associations in developing joint guidelines for the sale of mutual funds and other uninsured products. These guidelines, released February 1, 1994, are designed to help banks establish their mutual fund programs in a manner that ensures customers understand that mutual funds and other investment products are not backed by the bank, the FDIC, or any other government agency.

We sent a copy of these guidelines to every IBAA member. We urge that these guidelines, which were also sent to every member of this committee, be included as part of the hearing record.

The guidelines call on the banks to obtain a signed acknowledgment form from their mutual fund customers, it states that:

> **Nondeposit products: are not bank deposits; are not obligations of, or guaranteed by, any bank; are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency; and involve investment risk, including the possible loss of principal.**

The acknowledgement form goes beyond the interagency policy statement on retail sales of nondeposit investment products dated February 17, 1994. The interagency statement simply recommends that customers sign a statement acknowledging that they have received and understand the recommended disclosures.

Under the industry guidelines, disclosures must be made orally in sales presentations, sales calls, and advertising. Written disclosures must be signed <u>before</u> a sale. Disclosures must also be prominent, not buried or lost in the fine print.

The industry guidelines include important recommendations regarding the location of mutual fund sales. In general, the guidelines say that sales "should, to the extent permitted

by space and personnel considerations, take place in areas that are physically separate and/or distinct from routine retail deposit taking activities...." This takes into account the fact that many community banks operate out of offices that are just too small to provide separate rooms for mutual fund sales. In those cases, the guidelines recommend devices such as "handrails, shelves, display units, plant arrangements, furniture and equipment, signage, or some other means to distinguish the investment sales area from" retail deposit taking.

Much has been made of a recent SEC survey of mutual fund customers that purported to show that most customers who bought mutual funds from banks were confused about whether they were federally insured. Frankly, we believe that the SEC's conclusions were highly misleading and failed to tell the true story.

Though the SEC surveyed 1000 people nationwide, only 70 of the respondents had bought their mutual funds through a bank. Of this tiny group, 46 thought that their money was federally insured. From our perspective that is 46 too many. But a much more critical piece of information was that over a third of those who bought their mutual funds from a stockbroker also believed they had federal insurance. This points out the very serious need for better education on the part of the brokerage industry. As SEC Chairman Levitt said last week, investor protection must be a priority and we would urge the SEC to direct its effort toward the mutual fund companies that are aggressively targeting bank CD customers with little interest in investor protection.

For example, attached to my testimony are two advertisements by mutual fund companies that illustrate significant problems. The Oppenheimer advertisement compares FDIC insurance and SIPC insurance, concluding that customers are "safer" with SIPC insurance. Nothing could be further from the truth. Oppenheimer also urges consumers to move their funds out of the bank if viability is a concern, implying that they are in fact a safer investment choice. This ad makes no mention of the required disclosures about the risks a consumer could face from this type of investment including that these investments are **not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency; and that they involve investment risk, including the possible loss of principal.** These are disclosures that banks must and do make.

In the second advertisement, Fidelity Investments suggests customers call an 800 number to receive an educational guide entitled "Alternatives to Low Bank Rates." This ad at least mentions that Fidelity is not a bank and mutual funds are not FDIC-insured. Yet again, no mention is made that these investments involve risks including the possible loss of principal. This disclosure must appear on all mutual fund materials that a bank gives to customers and in all advertisements. From our perspective, the SEC could do a lot more in supervising the mutual fund companies that are targeting bank customers with misleading and incomplete disclosures. The mutual fund companies are contributing in large part to consumer confusion about mutual funds and yet the SEC seems to be turning a blind eye to these practices.

In fact, the SEC has proposed a rule that would substantially add to the confusion by permitting mutual funds to make sales using only newspaper ads. These "off the page" prospectuses are clearly inadequate for investor protection, containing none of the safeguards available to customers who buy their mutual funds at a bank.

In total contravention to its mission, the SEC justifies the use of off-the-page prospectuses "because over one quarter of U.S. households invest in mutual funds, either directly or indirectly...a significant portion of the investing public is generally familiar with what mutual funds are and how they operate." Familiarity with an investment option certainly does not demonstrate the understanding necessary to make an investment decision. Furthermore, off-the-page prospectuses could be used by the three-quarters of general public who do not have any knowledge of mutual funds to make an investment that, with adequate information, they may not have otherwise made. The fact that a large percentage of the American public has a checking or savings account did not deter Congress from passing the Truth in Savings Act.

For these reasons, IBAA strongly opposes the SEC proposal. It is especially important at this time when less sophisticated consumers are investing in mutual funds that consumers receive appropriate disclosures and are adequately protected. The SEC has stated that it is important to provide parity between direct-marketed mutual funds and broker-sold mutual funds. IBAA believes that instead of permitting off-the-page prospectuses, the SEC could also require brokers to deliver a prospectus to the investor with the appropriate disclosures before selling mutual fund shares. This would remedy the competitive inequities, but more important, it would do so without sacrificing investor protection.

Further Action by Congress or the Agencies

The IBAA strongly recommends that the Congress refrain from taking any action to restrict mutual fund sales by banks. Both the regulatory agencies and the industry itself have taken timely and comprehensive action to prevent customer confusion. We strongly urge Congress to give the agency and industry guidelines time to work. Customer education takes time and cannot be expected to be achieved overnight. We urge Congress to instruct the SEC to direct its effort to the mutual fund firms it oversees to ensure that all customers are provided with the appropriate and necessary disclosures about the investment risk associated with mutual funds.

It is particularly important for Congress to avoid writing overly detailed requirements into statute. Even if proposals, such as those in H.R. 3306, appear appropriate today, they could prove unworkable or ineffective when put into practice. Agency and industry guidelines can much more easily be adapted to changing circumstances or additional information.

We are particularly troubled by the location requirements contained in section 2 of H.R. 3306. The bill states that no "part of any banking office [may] be used for selling or

offering for sale, or for providing any opinion or investment advice with respect to, any nondeposit investment product." It requires that such products be sold in an area that "is physically segregated from the part of the office where deposits are accepted or withdrawn." This is much more rigid than the industry guidelines discussed above.

As I indicated earlier, many small banks and branches have only a small lobby area in the bank and no other offices or space in which to conduct business. The language of H.R. 3306 could prohibit these banks and branches from making mutual funds available to their customers because of space constraints.

We are also concerned about language in H.R. 3306 that prohibits a person who accepts deposits from referring customers to someone who may sell them a mutual fund. While we subscribe to the joint industry guidelines which state that "employees while acting as tellers should be prohibited from selling nondeposit investment products," we fail to see anything sinister in tellers simply making a referral to a bank's investment center without making general or specific recommendations about the products offered. To do otherwise could cause the bank to lose a customer. At the bank's investment center a customer can receive advice from a qualified professional who is required to provide them the full range of disclosures.

The bill permits teller referrals only if:

- "the customer explicitly requests such referral;" and

the teller:

- "does not solicit such request;"

- discloses that investment products are not insured; and

- "does not receive any compensation for the referral."

These requirements are so technical and legalistic a bank would almost have to instruct its tellers to deny that the bank has an investment center to avoid potential liability. This provision would be especially burdensome to a smaller bank where employees often wear several hats, including that of a teller. A properly trained investment representative should not be prohibited from filling in as a teller if the bank is short-handed one day. In short, we believe this provision is unworkable.

The agency guidelines deal with this area, permitting referrals, but only permitting nominal, fixed referral fees. This fee <u>cannot</u> be based on the success the sales representative has in closing a sale. This is fair and workable.

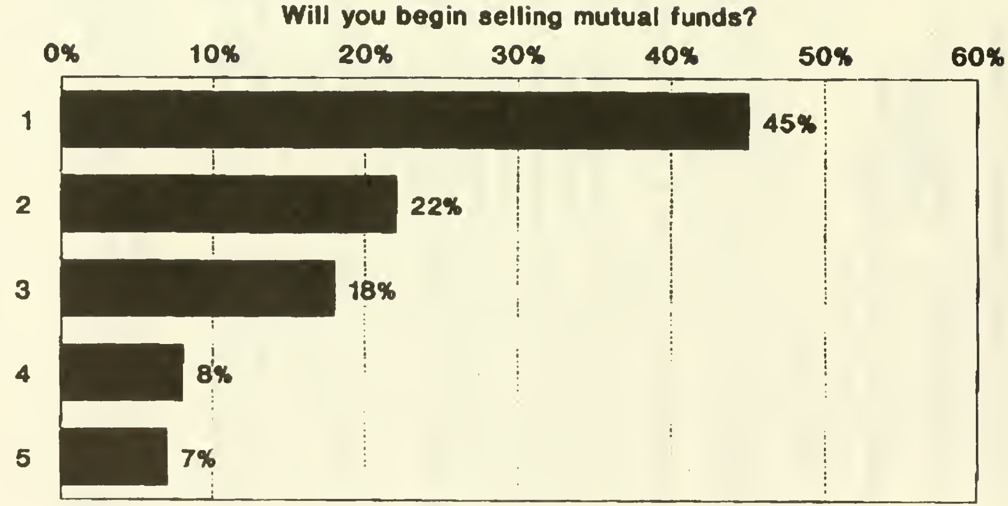
Conclusion

Banks are increasing their involvement in mutual fund sales because of customer demand. The industry and its regulators have taken positive steps to ensure that consumers clearly understand that mutual funds are not federally insured. Consumers are likely to get more thorough disclosures at a bank than at a securities firm, and certainly better disclosures than if they buy securities via an 800 number or through a newspaper ad.

We strongly urge Congress to let the industry and agency guidelines work before considering legislation. The banking industry knows its mutual fund sales activities are under close Congressional scrutiny. We also value our customer relationships and believe that the industry has a vested interest to take the steps necessary to provide investor protection without new burdensome laws that would unfairly advantage our competitors and drive customers away from banks.

We simply urge you to avoid passing legislation like H.R. 3306 that would impose inflexible rules on an evolving marketplace.

Among community banks that don't sell mutual funds, relatively few expect to start in 1994



1 = Not likely, 5 = Very likely

Source: Grant Thornton survey of 1,155 community bank senior executives, January 1994. Q11d (Base: 900 responses)

IMPORTANT POINTS REGARDING IPI PROGRAM

(1) Separate area designated for investment sales.

(2) Clearly separate and distinct signage.

(3) Separate Phone Lines.

(4) Customer warnings on all signage, promotional material and trade confirmations.

(5) Registered Representative is not a bank employee.

(6) Registered Representative does not have dual duties.

(7) Customer is apprised of all disclosures verbally as well as in writing.

(8) Most of the assets coming into the investment program originate from outside of the Bank; Specifically - other brokerage firms.

(9) There is absolutely no question in the customers mind that investment sales are being transacted by IPI - not the Bank.

(10) Periodic training sessions are held for Bank employees which stress the separate and distinct nature of the Broker/Dealer contractual relationship and educate employees as to what they can or cannot say.

(11) Bank has adopted its own compliance plan to actively monitor investment sales. Bank has complete access to all trade and investment holdings information and receives monthly reports regarding brokerage activity.

We thought you should know...

Some bank customers recently have sought alternative investments to bank deposits in an effort to increase the yield or interest earned. While mutual funds may be a viable part of many financial plans, we want you to know of the following facts if you are considering purchasing mutual funds:

- Mutual funds are not federally-insured deposits. Mutual funds purchased at FDIC-insured banks are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or by any other government agency, nor are they guaranteed by the bank.

- Investments in mutual fund shares are subject to risk, including the possible loss of principal. The value of the investment may fluctuate. When mutual fund shares are sold, their value may be higher or lower than the amount originally invested.

- Our bank's deposits are reinvested into our community as investments and loans to individuals and local businesses. Mutual funds, however, invest more broadly and therefore do not generally contribute directly to the local economy.

As today's investors search for higher returns and explore alternatives to traditional savings accounts and certificates of deposit, mutual funds are gaining popularity. We believe that mutual funds, if appropriate for you, should be viewed as long-term investments, not substitutes for insured bank deposits.

Member Independent Bankers Association of America, representing the nation's community banks.

Attention All Clients
With Bank Held Retirement Assets

Effective December 19, 1993, FDIC insurance coverage on your aggregate retirement assets held at a bank will drop from $400,000 to $100,000. For many, a portion of retirement assets may be left uninsured by the FDIC. Why leave your hard-earned retirement assets at risk?

Oppenheimer has a solution. Your aggregate retirement assets held at Oppenheimer & Co., Inc. are insured through SIPC up to $500,000 per tax ID number. We have also purchased an additional $2,000,000 in coverage through a private insurer. Oppenheimer clients with assets whose market value is in excess of $2,500,000 are eligible to be considered for inclusion in the Preferred Client Program. Preferred clients are insured up to $25,000,000.

If the viability of your bank is a concern, you should consider moving your assets out of your bank and into an appropriate investment at Oppenheimer. Please contact your Oppenheimer broker with any questions you might have.

Oppenheimer & Co., Inc.
Retirement Services Department

NEWS

➤ New features on Fidelity TouchTone Trader℠, our automated trading service, are coming in March. These features give brokerage account customers more ways to place trades and check the status of orders. Besides being able to buy and sell stocks, options, and Fidelity mutual funds, you'll be able to buy and sell any of the more than 1,500 non-Fidelity mutual funds in our FundsNetwork. You will also be able to check the status of any order in your brokerage account to see if it has been filled or is still open. To use the service call 1-800-544-0202.

➤ If you're a bank customer thinking about transferring your savings to your Fidelity mutual fund account, you can do it automatically with our Savings Transfer Service. You can make transfers from statement savings accounts, money market accounts, and maturing CDs. For help choosing a fund, request our educational guide "Alternatives to Low Bank Rates." Call 1-800-544-8888 for a transfer application and a booklet. (Fidelity is not a bank and mutual funds are not FDIC insured.)

➤ Now you can invest in Fidelity Equity-Income Fund and pay no sales charge. The 2% sales charge on this dividend-paying stock fund is waived through December 31, 1995.

For more complete information on any Fidelity fund, including charges and expenses, call 1-800-544-8888 for a current prospectus. Read it carefully before you invest or send money.

Exchange Fee Waivers

Special Savings for Spartan and Select Investors

Investors in Spartan® funds and Fidelity Select Portfolios® can avoid exchange fees by using Fidelity's convenient automated services. Just use Fidelity On-line Xpress℠ (FOX), our PC-based investment software package; the Mutual Fund Exchange Line; or TouchTone Trader to exchange out of these funds and you won't be charged the usual $5 Spartan and the $7.50 Select Portfolio exchange fees.

For more complete information, including charges and expenses, call 1-800-544-8888 for a current prospectus. Read it carefully before you invest or send money.

Fidelity reserves the right to terminate or modify the exchange privilege at any time.

Save on Sales Charges

Take a Break

Some investors can now get a break on sales charges when they invest in Fidelity equity mutual funds. When the sum of your individual account balance and investment reaches $250,000 or more, the sales charge on any new, additional, or exchange investments going into the fund will be reduced. The following chart shows the specific savings.

NEW SAVINGS ON SALES CHARGES

Investment Amount per Fund Account	Load Charged	Range of Savings
$0 to $249,999	3%	None
$250,000 to $499,999	2%	$2,500 to $5,000
$500,000 to $999,999	1%	$10,000 to $20,000
$1,000,000 and greater	0%	$30,000 and greater

For more complete information, including charges and expenses, call 1-800-544-8888 for a current prospectus. Read it carefully before you invest or send money.

ILLUSTRATIONS: LEFT: JULIA GORTON RIGHT: DANIEL PELAVIN


Six steps to
building a stronger
financial future
1 Determine your goals and priorities
2 Review your current financial situation
3 Identify your investment style
4 Select investments that match your goals and investment style
5 Evaluate your investment choices
6 Start today!
IBAA
FINANCIAL SERVICES
CORPORATION

What is the purpose of this Workbook?

The purpose of this Workbook is to give you the opportunity to gather the information that you and your IBFS registered representative will need to develop the best plan for your long-term goals.

This Workbook is part of a personalized investment planning program — a six-step process designed to help you build a stronger financial future. The more information you are able to provide, the more accurate your plan will be.

Assistance from the Financial Asset Builder™

To better meet your needs, the mutual fund program at your bank offers the Financial Asset Builder — a specially designed software program that your IBFS registered representative will utilize throughout the six-step planning process. The Financial Asset Builder will give you the opportunity to see where your financial strengths and shortfalls are, weigh the many different investment options, and participate in building the best plan for your future.

The investment products offered at your bank are not insured by the FDIC or any other government agency, and are not deposits of, obligations of, or guaranteed by, your bank. Shares of mutual funds are subject to risk, including possible loss of principal, and may fluctuate in value. You may receive more or less than you paid when you redeem your shares. Please see the prospectuses for details.

Take charge of your future with the Financial Asset Builder

Six steps to building a stronger financial future with the Financial Asset Builder

1 **Determine** your goals and priorities
- Your short-term goals
- Your long-term goals

2 **Review** your current financial situation
- Your investments to meet short-term goals
- Your investments to meet long-term goals

3 **Identify** your investment style
- Conservative
- Moderate
- Aggressive

4 **Select** investments that match your goals and investment style
- Safety of principal
- Growth of capital
- Current income
- Tax-free income

5 **Evaluate** your investment choices
- Features and benefits of mutual funds
- Investment objectives, historical performance, and costs of the mutual funds you are considering
- Reputation and experience of the mutual fund company

6 **Start today!**

Before you begin...

Your name ______________________

Address ______________________

____

Home phone ______________________

Work phone ______________________

Spouse's name ______________________

Number of children/dependents __________

Children's/dependents' ages __________

Determine your goals and priorities

Please check the boxes that apply to you.

Your short-term goals	Your long-term goals
(Three years or less)	(More than three years)
☐ Emergency fund	☐ Comfortable retirement
☐ Car	☐ Health and medical expenses
☐ Vacation or travel fund	☐ Reduced taxes
☐ Wedding	☐ Estate planning
☐ House down payment	☐ Working capital to start a business
☐ Reduced taxes	☐ A college fund
☐ Higher current income	
Other (please list)	Other (please list)
☐ ________	☐ ________
☐ ________	☐ ________
☐ ________	☐ ________

By identifying your goals, you lay the foundation for your financial plan.

2 Review your current financial situation

List your assets for your short-term and long-term goals.

List your short-term assets		List your long-term assets	
(For safety of principal and current income)		(For current income and/or growth of capital and income)	
☐ Savings accounts	$ ______	☐ U.S. Government bonds	$ ______
☐ Money market accounts	______	☐ Municipal bonds	______
☐ CDs	______	☐ Corporate bonds	______
☐ U.S. Treasury bills and notes	______	☐ Stocks	______
Other (please list)		☐ Annuities	______
☐ ______	______	☐ Mutual funds	______
☐ ______	______	☐ IRAs	______
		☐ Employer pension plan	______
		☐ 401(k)	______
Your total short-term assets	$ ______	Other (please list)	
		☐ ______	______
		☐ ______	______
		Your total long-term assets	$ ______
		Your total short-term and long-term assets	$ ______

Your IBFS registered representative will help you evaluate whether your assets are balanced properly to help achieve your goals.

3 Identify your investment style

- Please check off your answers to questions in the Confidential Investment Questionnaire
- Total the scores corresponding to each of your answers
- Identify your investment style, based on your total score
- Confirm with your IBFS registered representative that your score matches your investment goals and attitudes

Confidential Investment Questionnaire

	Score
1 What is your age?	
☐ a. 18 – 29	(30)
☐ b. 30 – 44	(20)
☐ c. 45 – 54	(20)
☐ d. 55 – 64	(10)
☐ e. Over 65	(10)
2 How many financial dependents do you have?	
☐ a. None	(15)
☐ b. One	(10)
☐ c. Two to three	(5)
☐ d. More than three	(5)
3 What is your employment status?	
☐ a. Employed full time	(15)
☐ b. Employed part time	(5)
☐ c. Self-employed	(10)
☐ d. Retired	(5)
☐ e. Not employed	(0)
4 What is your current combined federal and state tax bracket?	
☐ a. 28% or more*	no score
☐ b. Less than 28%	no score
☐ c. Not a concern due to current tax deductions	no score

* If you've checked 4a, you may be a tax-sensitive investor.

5 Which of the following best describes your future salary/income potential?

- ☐ a. Expect increases to far outpace inflation (15)
- ☐ b. Expect increases to somewhat outpace inflation (10)
- ☐ c. Expect increases to keep pace with inflation (10)
- ☐ d. Expect increases to be less than inflation (5)
- ☐ e. Not applicable — unemployed or retired (5)

6 Do you have an emergency fund?

- ☐ a. No (0)
- ☐ b. Yes, less than three months of after-tax income (0)
- ☐ c. Yes, between three and six months of after-tax income (30)
- ☐ d. Yes, I have adequate emergency dollars (45)

7 Have you ever invested in stocks or stock mutual funds?

- ☐ a. No, and I am not comfortable with stocks (10)
- ☐ b. No, but I am interested in learning about it (15)
- ☐ c. Yes, but I was not comfortable with stocks (10)
- ☐ d. Yes, and I was comfortable with stocks (30)

8 Have you ever invested in bonds or bond mutual funds?

- ☐ a. No, and I am not comfortable with bonds (10)
- ☐ b. No, but I am interested in learning about it (15)
- ☐ c. Yes, but I was not comfortable with bonds (10)
- ☐ d. Yes, and I was comfortable with bonds (20)

9 Most of your current investment dollars are in:

- ☐ a. CDs and/or savings accounts (15)
- ☐ b. Government/corporate/ municipal bonds (30)
- ☐ c. Mutual funds — stock and/or bond (30)
- ☐ d. Individual stocks (45)

10 Your primary investment objective is:

- ☐ a. Safety of principal no score
- ☐ b. Current income with potential for above-average returns no score
- ☐ c. Tax-free income* no score
- ☐ d. Long-term growth of capital and income no score

* If you've checked 10c, you may be a tax-sensitive investor.

11 You are more comfortable with:

- ☐ a. Safety of principal while sacrificing returns (15)
- ☐ b. Above-average returns with principal fluctuations (30)
- ☐ c. Maximum returns with wide fluctuations (45)

Your total score ______________

Your total score will help you identify your investment style.

(continued)

Identifying your investment style based on your score

Check the box below that corresponds to your total score. If you disagree with our description of your investment style, please jot down your reasons and discuss them with your IBFS registered representative.

☐ If your total score is 105 or less, you are most likely a saver, which means most of your savings should be in FDIC-insured bank savings accounts, CDs, and/or money market accounts. If you are interested in starting a long-term investment program, a monthly investment plan may be appropriate. Ask your IBFS registered representative about the benefits of "dollar-cost averaging."

☐ If your total score is between 110 and 160, you are most likely a conservative investor, and your primary investment concern is safety of principal. For that you are willing to give up the potential for above-average long-term returns.

☐ If your total score is between 165 and 210, you are most likely a moderate investor, and you want to balance your needs for both preservation of principal and long-term growth of capital. Therefore, you are willing to accept price fluctuations in your long-term investments to have the potential for above-average returns.

☐ If your total score is between 215 and 260, you are most likely an aggressive investor, and you are looking for long-term growth of capital and income. To meet your long-term goals, you may choose investments with the potential for maximum long-term returns, and you are willing to accept wide price fluctuations.

Once you identify your investment style, you and your IBFS registered representative can select the investment strategy and the investment mix that you'll feel comfortable with.

Examples of investment strategies that match different investment styles

These are general suggestions. Your IBFS registered representative will help you determine the best strategy and investment mix for your individual goals and investment style.

Congratulations!

You have completed the first three steps to building a stronger financial future

1 You have identified your short-term and long-term goals.

2 You have evaluated your current financial situation and taken inventory of your short-term and long-term assets.

3 You have identified your investment style and evaluated examples of investment strategies that match different investment styles.

Now you are ready to take the final three steps to start making your goals a reality

4 **Select investments that match your goals and investment style.**
Your IBFS registered representative will work with you to select the best blend of MFS mutual funds and bank deposit products to help you pursue your goals.

5 **Evaluate your investment choices.**
Your IBFS registered representative will explain the objectives, strategies, historical performance, and costs of the MFS mutual funds suggested for you.

6 **Time is money, so start today!**
You've already done the hardest part. Now contact your IBFS registered representative to start making your goals a reality.
Call today!

What's next?

- Ask at the bank how to contact your designated IBFS registered representative and where you can find the information and literature you need to invest. All the materials are located at the bank for your convenience
- Using the computerized Financial Asset Builder program, your IBFS registered representative will combine the information from steps 1, 2, and 3 to help you chart the best course for your financial future
- You may want to review the companion piece to this Workbook, *Six steps to building a stronger financial future*, for more information on steps 4, 5, and 6. It's in your folder

Questions and Answers

Q. Who developed the mutual fund program at my bank?

A. The program was developed by IBAA Financial Services Corporation (IBFS), an NASD-registered broker-dealer. IBFS is a subsidiary of the IBAA Community Banking Network® and the IBAA, the Independent Bankers Association of America. The IBAA, a nonprofit association, is dedicated to helping community banks provide high-quality products and services to customers nationwide.

Q. Who is the mutual fund company in the IBFS program?

A. IBFS has selected a mutual fund company with an unmatched tradition. MFS, Massachusetts Financial Services Company, traces its history to the creation of America's first mutual fund, Massachusetts Investors Trust, in 1924. Through bull markets and bear markets, world wars and cold wars, recessions, expansions, and even the Great Depression, Massachusetts Investors Trust and MFS have helped generations of investors achieve their financial goals.

MFS currently manages over $33 billion in assets for more than one million investors,[1] and has a long record of proven performance and top-rated customer service.

Q. What is the Financial Asset Builder?

A. The Financial Asset Builder is a software program designed to take you through the six steps we have discussed here. By going through every step with your IBFS registered representative, you'll have an opportunity to see where your financial strengths and shortfalls are and participate in building the best plan for the future. Depending on your bank's program, the Financial Asset Builder workstation may be available at the bank, or at IBFS headquarters.

Q. How does the Financial Asset Builder help me build a financial plan?

A. Your IBFS registered representative will input the information you provide in each of the six steps. The Financial Asset Builder program will compile your data into a suggested asset allocation model, based on your investment style. Your IBFS registered representative will review with you the asset allocation suggestions to develop an overall financial program that best meets your individual needs.

Q. Does the IBFS program offer a sufficient number of mutual funds to meet all my needs?

A. The investment professionals at IBFS understand that your financial needs and goals change as you go through different stages of life. That's why the IBFS program gives you a broad selection of professionally managed MFS mutual funds in all major investment categories — to help you invest for income, tax savings, and/or growth of capital.

Q. How often should I review my financial plan with my IBFS registered representative?

A. Generally, it's a good idea to review your plan at least once a year. In addition, you should contact your registered representative whenever your financial circumstances significantly change.

[1] As of October 31, 1993.

About IBAA Financial Services Corporation (IBFS)

IBFS is an NASD-registered broker-dealer whose mission is to provide time-tested, quality investment alternatives to community banks and their customers.

IBFS is a subsidiary of the IBAA Community Banking Network® and the IBAA, the Independent Bankers Association of America. The IBAA, a nonprofit association, is dedicated to helping community banks provide high-quality products and services to customers nationwide.

The investment products offered at your bank are not insured by the FDIC or any other government agency, and are not deposits of, obligations of, or guaranteed by, your bank. Shares of mutual funds are subject to risk, including possible loss of principal, and may fluctuate in value. You may receive more or less than you paid when you redeem your shares. Please see the prospectuses for details.

IBAA FINANCIAL SERVICES CORPORATION
A SERVICE OF THE IBAA COMMUNITY BANKING NETWORK®

MFS℠
The First Name in Mutual Funds · Since 1924

This publication is authorized for distribution to investors only when preceded or accompanied by a current prospectus for the MFS fund(s) being offered. A prospectus for any of the selected MFS funds is available from your IBFS registered representative. Read the prospectuses carefully before you invest or send money.

500 Boylston Street, Boston, MA 02116 IBFS-6A-1/94/25M

STATEMENT

of

RAY MARTIN
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
COAST FEDERAL BANK

on behalf of

SAVINGS & COMMUNITY BANKERS OF AMERICA

on

BANK SALES OF MUTUAL FUNDS

before the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND DEPOSIT INSURANCE

HOUSE OF REPRESENTATIVES

March 8, 1994

Mr. Chairman and members of the Subcommittee, my name is Ray Martin, I am the Chairman and Chief Executive Officer of Coast Federal Bank headquartered in Los Angeles, California. Coast has $8.1 billion in assets and operates 88 branch offices throughout California. I am pleased to appear before the Subcommittee on behalf of Savings & Community Bankers of America ("SCBA") to comment on H.R. 3306 and the circumstances in which depository institutions sell uninsured products.

Overall Position

SCBA supports the ability of depository institutions to compete freely with nondepository institutions in offering uninsured products such as mutual funds and annuities to retail customers. In conducting these sales, it is essential that institutions adopt appropriate safeguards to ensure customer awareness of the risks as well as the returns from investing in these products.

Offering mutual funds and annuities permit institutions to meet the broad investment needs of consumers in locations that serve their convenience. Many consumers thereby avoid the necessity of dealing with unfamiliar stock brokers or insurance companies. They prefer the convenience of "one-stop" shopping for financial services -- including insured deposits, uninsured investment products, and various loan arrangements. This enables institutions to retain existing customers and attract new customers. The institution is also able to generate essential fee income in highly competitive and highly regulated financial markets.

Industry Activity

Savings institutions are active participants in the marketplace for selling nondeposit investment products. Based on a survey of a sample of SCBA members, 17.5 percent sell mutual fund shares and 19.4 percent sell variable-rate annuity products. Additionally, 14.8 percent of SCBA members provide brokerage of stocks and bonds. Only a handful of member institutions offer proprietary mutual funds. The savings institutions that sell securities-type products are represented in each region of the country and are distributed broadly among mutual- and stock-owned institutions. The average size of SCBA members selling securities-type products is $670 million in assets compared to an average size of $430 million in assets for all SCBA members.

It may be appropriate to mention that in many cases, SCBA member institutions have entered into this business as a defensive strategy. Given that a significant component of sales to existing customers are cleared by reducing savings or checking account balances at the institution, SCBA members are not nearly as motivated to close the mutual fund sale as a brokerage house where this is the only relationship with the customer.

Coast Federal Bank, through its subsidiary Coast Fed Investments and Insurance (CFI&I), makes nondeposit investment products conveniently available to its customers. Since 1988, Coast has offered fixed annuities to its customers and Coast customers have invested over $1 billion in fixed annuities. In April of 1993, Coast expanded its product line to include mutual funds. We offer a wide range of mutual funds and annuity investment products for our customers. These include 28 mutual funds and two variable annuity products.

Coast's nondeposit investment products are made available through unaffiliated insurance and mutual fund companies. Mutual funds are offered through a registered broker/dealer, FIMCO Securities Group (FSG), a third-party broker/dealer.

The focus of my remarks at these hearings is on H.R. 3306, "Depository Institution Retail Investment Sales and Disclosure Act" and the recent initiatives by the industry and the federal banking agencies to provide guidance to institutions in selling uninsured products. I will also address the recent proposal by the Securities and Exchange Commission ("SEC") to permit investment companies to engage in direct-marketing sales of mutual funds in advance of regular disclosures to customers.

Safeguards for Selling Uninsured Products

The sales of uninsured products by depository institutions have come under increased scrutiny by these institutions, their trade associations, and the federal banking agencies to prevent misleading sales practices. Separate surveys sponsored by the SEC and jointly by the American Association of Retired Persons and the North American Securities Administrators Association indicated that a high proportion of mutual fund investors at banks believe their mutual funds are federally insured. This consumer confusion, I might add, is not limited to sales at banks and savings institutions. The SEC survey found that 36 percent of the respondents believe that mutual funds purchased from a stock broker are federally insured and 28 percent believe that mutual funds sold through banks are federally insured. Although the statistical validity and rigor of these surveys have been questioned, the message is clear -- the industry must do more to ensure that consumers are perfectly aware of the differences between insured and uninsured products.

Industry Guidelines

The trade associations and the agencies are responding to this challenge in a decisive and responsible manner. SCBA and the other national banking trade associations developed guidelines to serve as the industry standard for the sale of mutual funds and other uninsured products by the nation's banks and savings institutions. The guidelines were announced at a press conference on February 1st; The guidelines are comprehensive and "user-friendly."

When SCBA sent the guidelines to each of its members, it strongly urged their adoption. In addition, the new section in the Comptroller of the Currency's Handbook for National Bank Examiners (OCC Bulletin 94-13, February 24, 1994) states that "Examiners also should encourage bank management to review Retail Investment Sales: Guidelines for Banks. The publication, prepared jointly by six banking industry trade associations, contains voluntary guidelines for bank sales of nondeposit investment products as well as common sense suggestions for putting many of the OCC's recommendations into action." Ideally, the other banking agencies will provide the same advice to their examiners.

The guidelines cover a wide range of factors that an institution should consider in its uninsured product sales program. Emphasis is on the need for a physically distinct location for the sales of uninsured products, proper disclosure of the potential loss of principal and lack of deposit-type insurance coverage, investment recommendations based on suitability for a specific customer, appropriate criteria for employee compensation and employee fees, adequate managerial and auditing controls, and an approach to resolve disputes with customers.

Agency Activity

On February 15th, the federal banking agencies adopted uniform interagency policies governing the retail sales of nondeposit investment products. These interagency policies were developed independently of the initiatives of the trade associations, but they are similar in virtually all respects. However, the industry guidelines are unique in containing a sample format of an investment product acknowledgment form, a detailed presentation of applicable laws and regulations governing the sales of uninsured products, a detailed discussion of product suitability criteria and a sample agreement for arbitration of disputes.

The efforts of the trade associations and the bank regulators strike a reasonable balance between vigorous self-policing of uninsured product sales at depository institutions, sound supervision by the agencies, and the necessary flexibility of institutions to profitably engage in these activities. The industry guidelines are an attempt to complement the interagency policy statement.

SCBA Initiatives

Several SCBA initiatives are underway to help educate the consumer and help the industry implement effective uninsured product sales programs.

SCBA is writing and funding a consumer education column on the differences between investing in insured products and uninsured products such as mutual funds and annuities. The written "Q & A spot" will be sent to 10,000 small and mid-size daily and weekly newspapers across the country for publication.

4

SCBA undertook to improve the usefulness of the consumer information pamphlet developed by the banking regulators discussing the differences between bank accounts and uninsured investments. Though the full text was retained, the somewhat confusing complete list of federal banking regulators was eliminated in favor of the disclosure of the single, primary federal regulator of the depository, and the space so created was made available to imprint the individual depository institution name. The goal was to make the pamphlet even more "user-friendly" for inclusion in various mailings or on countertop displays.

SCBA and 22 state trade organizations are cosponsoring a series of educational seminars for their members in six cities across the country in May and June on the topic of uninsured products. These sessions will provide information about marketing, operations and regulations concerning these products, including particular attention to the voluntary guidelines recently adopted by the national trade associations. In addition, SCBA is offering sessions at two Spring management conferences on the challenges and opportunities of offering uninsured products.

SCBA's flagship graduate management program, the National School of Banking, in Fairfield, Connecticut, thoroughly reviews the strategic, financial, compliance and service issues related to the sale of mutual funds. This six-week senior officer program with over 3,000 alumni has incorporated the industry guidelines on uninsured products and staff training requirements into its curriculum and case studies.

Institutions like Coast are in the process of evaluating the use of customer follow-up programs to verify that customers are properly informed on an on-going basis. The options under consideration include a targeted call back program, a mystery shopper program, or periodic customer surveys. SCBA is monitoring industry efforts and will develop a model form an institution can use to periodically survey its customers on the effectiveness of its disclosures relating to uninsured products.

SCBA has established a system, via one of its subsidiaries, whereby member institutions that are seeking to engage in sales of uninsured products as a new line of business can find the right type of third-party provider for a joint venture. A failure to ensure a meeting of the minds on marketing strategy could reduce the care with which such products are discussed with customers in the quest to generate unrealistic sales results from a particular customer base.

The SCBA subsidiary engaging in this matchmaking process carefully considers the fit between the depository institution's and securities operation's marketing strategy and culture before suggesting the best way to structure the relationship.

It is important that security industry sales personnel with a record of regulatory violations do not view the growing operations of depository institutions in marketing uninsured products as virgin territory within which to continue unethical practices. Via a subsidiary, SCBA is

providing its members access to a national computer database containing full records of all enforcement actions taken by financial sector regulators against sales and management personnel. The database covers depository institution regulators, the SEC, NASD, state securities and insurance regulators, and CFTC. Dial-up access to screen potential employees and vendors is available. A reputable, well-trained, and ethical workforce is essential if disclosures are to be effectively delivered to customers.

In light of various initiatives underway in the industry, and at both the associations and the regulatory agencies, legislation at this time is unnecessary. Locking institutions into rigid statutory procedures would reduce the needed flexibility of institutions to periodically reevaluate and modify their uninsured product sales programs to best serve their customers. In the final analysis, customers will be the best judges of how conveniently and efficiently institutions are satisfying their investment needs on a properly informed basis. Customers should be actively involved as a feedback mechanism for new or existing sales and disclosure approaches. Legislation or additional complex regulations will not provide the answer.

<u>H.R. 3306</u>

In many respects, the legislation under consideration at these hearings contains provisions already addressed by the trade associations and the federal banking agencies. While adequate consumer disclosures and sound product suitability standards are essential, various restrictions contained in the proposed legislation would adversely affect the ability of depository institutions to compete effectively in the mutual funds and annuities marketplace. The most restrictive provisions in H.R. 3306 relate to overly rigid locational segregation of insured and uninsured product sales, absolute prohibitions on employees selling both insured and uninsured products, excessive limitations on employee referrals and referral compensation, and overly restrictive limitations on the use of customer information for marketing uninsured products.

The following is an analysis of the legislation in relation to the industry guidelines, the interagency policy statement and Coast's owned practices.

<u>Scope of Coverage</u>

H.R. 3306 would apply only to <u>retail</u> sales of nondeposit investment products at any office of, or on behalf of, the institution. The language is vague with respect to the treatment of affiliated and unaffiliated entities.

The industry guidelines are more explicit in including these entities under all provisions in the guidelines. In addition to on-premises sales, the guidelines cover sales by telephone, through the mail, or at a residence or place of business of the prospective customer. Retail sales covered in the guidelines appropriately exclude large denomination products and sales to sophisticated customers.

Rules of Fair Practices

Section 44(c)(3) would require the federal banking agencies to jointly prescribe rules to take into account the Rules of Fair Practices of the National Association of Securities Dealers ("NASD") and other applicable rules or regulations.

The industry guidelines are very specific on this point. It is clearly noted that "these guidelines are intended to work in tandem with the rules of the Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers, Inc. ("NASD"), to the extent those rules are applicable. Special attention should be given to NASD Notice to Members 93-87, December, 1993."

A separate section of the guidelines is devoted to applicable laws and regulations an institution should consider, after consultation with legal counsel, that may apply to the sale of securities or annuities. The Comptroller of the Currency's new guidelines for examiners appropriately notes the relevance of anti-fraud provisions of the federal securities laws and NASD Rules of Fair Practices as part of the minimum standards for nondeposit investment programs.

Disclosure Requirements

Section 44(d) contains written disclosure requirements and requirements for advertising and promotional material. The federal banking agencies would be required to establish model forms for the various disclosures in this subsection. The following written disclosures would be required: (1) the nondeposit investment product is not insured by the Federal Deposit Insurance Corporation, the United States Government, or the institution; (2) the product poses some investment risk and the risk may involve the loss of principal; (3) a clear description of the relationship between the depository institution and any other person which originated the products or are otherwise directly or indirectly involved with underwriting, selling, or distributing the product; and (4) the relationship between the institution (or any affiliate) and the investment company offering shares for investment. The institution would be required to obtain a signed statement from the customer at the initial purchase of each type of investment product (i.e., mutual fund, annuity or shares of stock). In the case of subsequent purchases through electronic or telephone fund transfers, a visual or oral notice may be provided in lieu of certain written disclosures. The specified disclosures that would be required for the signed declaration by customers must also be included in all advertising and promotional material.

The major disclosures that would be required in this subsection are already covered in the industry guidelines and the interagency policy statement. These documents emphasize that the disclosures should be both in writing and in oral presentations. Attachments I-III contain a brief description of Coast's efforts in this area.

7

The model acknowledgment form contained in the industry guidelines does not provide for a description of the relationship between the institution and a registered investment company or the person who underwrites, sells or distributes the product. While Coast includes this information on its acknowledgement form, these disclosures are more meaningful to the consumer in oral presentations and written advertising and marketing material. To avoid confusing a customer with extraneous material on the acknowledgment form, this form should be used primarily to verify the customer's understanding of the specific risks associated with the investment product being sold.

The industry guidelines recognize the importance of the corporate distinction between the institution and the broker/dealer or mutual fund. It must be clear to the consumer that the product being offered is not a bank product and that the broker-dealer or mutual fund are separate corporate entities. While the institution should be able to freely promote the products it sells, it should be the responsibility of the mutual fund or broker/dealer to describe the benefits of investing with their firm. If the institution has an advisory relationship with the mutual fund, it should disclosure this relationship orally to the customer. In general, disclosure of material relationships between the institution (or an affiliate) and the mutual fund should be in writing. This disclosure could be satisfied through the mutual fund prospectus.

Locational Requirements

Section 44(e) would limit the sale or investment advice with respect to nondeposit investment products to areas that are physically segregated from the part of the office where deposits are accepted or withdrawn. In areas where nondeposit investment products are sold, the institutions would be required to post a notice stating that the section of the office is devoted to the sale of nondeposit investment products that are not insured by the FDIC, the U.S. Government, or the institution, and that deposits are not accepted at that location.

This represents one of the most controversial and possibly burdensome provisions in the proposed legislation. To avoid customer confusion, the industry guidelines urge institutions, to the extent permitted by space and personnel considerations, to sell uninsured products only in areas that are physically separate and/or distinct from the routine retail deposit-taking activities. The guidelines recognize the difficulty of providing segregated areas in small branch offices and would permit institutions to sell both insured and uninsured products in the "platform" areas in the lobby with proper signage or distinguishing devices.

Coast designates all investment areas with directional signage showing "Investment Center". These signs are either hung from the ceiling or are free standing. Where applicable, the Investment Center is a separate office within the branch or if the desk is located in the branch office, the area is separated by signs, plant arrangements and display racks. All designated investment desks are required to prominently display a sign showing that these products are not FDIC-insured and show Coast's disclosure.

Absolute physical separation of sales of insured and uninsured products may not be as necessary in cases in which deposits and only fixed-rate annuities are offered in the same area. While there are some unique risks involved with fixed-rate annuity products, in many respects this product is more akin to a certificate of deposit ("CD"). Like a CD, a fixed-rate annuity provides that the full principal will be paid back upon demand plus interest (less any surrender charges). The interest rate is guaranteed for a limited time and is then subject to change at expiration of the initial interest-rate guarantee period. Obviously, the lack of federal insurance of this principal and interest and the other appropriate disclosures, including rating of the insurance company sponsor, must be disclosed in a clear way.

Product Suitability, Employee Qualifications, and Training

Section 44(f)(1) would prohibit a person who accepts deposits from selling or offering investment advice regarding nondeposit investment products.

This is an overly-restrictive requirement. The industry guidelines and Coast's experience recognize the importance to customers of having a person, qualified and trained to sell both insured and uninsured products, being able to advise the customer on the suitability of each product within the context of the customer's overall investment needs. This is not to say that such dual sales arrangements are appropriate in all cases. Proper disclosure of the distinctions between insured and uninsured products must have the highest priority. Another criterion for permitting dual sales arrangements should be the standards for determining the suitability of insured and uninsured products. If rigorous disclosures and product suitability criteria are met, the industry guidelines and the interagency policy statement permit qualified individuals to sell both insured and uninsured products.

Section 44(f)(3) specifies qualification requirements and suitability considerations. This subsection would require that nondeposit investment products be sold only by sales personnel registered with the SEC as a broker/dealer, registered representative, or investment advisor, or an individual that meets the qualifications and training requirements that the federal banking agencies deem equivalent. Sales representatives should be trained to make accurate judgments about the suitability of particular nondeposit investment products for a prospective customer.

These requirements are consistent with those contained in the industry guidelines and the interagency policy statement. However, the suitability and training requirements specified in the industry guidelines are far more comprehensive.

The industry guidelines urge banks and savings institutions to offer uninsured products suitable to each customer's individual investment needs and financial circumstances. Sales representatives should inquire about each customer's financial sophistication, personal financial situation, investment horizon and objectives, risk tolerance, and other relevant information. Prudent risk diversification should be a factor in the sales presentation. The

sales representative's guiding philosophy must be "know your customer."

The guidelines detail practices that would be inconsistent with customer suitability. For example, sales representatives should not encourage customers to churn their mutual fund accounts. It is also improper to recommend the purchase of securities that are inconsistent with any reasonable assessment of the customer's investment objectives or financial capacity. Nor should sales representatives purport to guarantee a customer against loss in any securities transaction.

An institution must have qualified employees properly trained to sell uninsured investment products. Professional standards for this sales effort should be equivalent to those in the securities business. Institutions must also ensure that the level of risk involved in investment products is properly disclosed to each customer.

Bank management, sales representatives, and audit and compliance personnel involved with the institution's sales program, as well as all other employees indirectly involved, should complete the training appropriate to their role within the program.

Coast's investment subsidiary (CFI&I) requires that all sales be accompanied by a signed customer financial inventory (see Attachment IV). This financial inventory lists the customer's investment goals, risk tolerance, financial background, tax status, etc. The financial inventory is used by the Investment Specialist to determine a suitable investment type for each customer along with identifying the customer's financial background. Background checks are done on all employees who are licensed to sell nondepository investment products as well as all new employees who are to be licensed to sell nondeposit investment products. These checks are designed to turn up previous enforcement actions by any federal or state regulator.

CFI&I conducts an investment product class to train newly-licensed employees on compliance issues, product information, legal restrictions and customer concerns. On-going workshops are provided to licensed employees on legislative issues, product changes, and customer needs and servicing. Training is also provided for non-licensed employees regarding the appropriate way to refer a customer to an Investment Specialist and how to answer customer inquiries by referring customers to the Investment Specialist.

<u>Referrals and Referral Fees</u>

Section 44(f)(2) would permit an individual that accepts deposits to refer a customer to a sales representative for uninsured products only if the person who accepts the deposits does not solicit such a request and discloses to the customer that the product is not insured by the FDIC, the United States Government, or the institution. The individual making the referral would not be allowed to receive any compensation for the referral.

The conditions governing referrals are treated differently in the industry guidelines and the interagency policy statement. Tellers should be prohibited from selling nondeposit investment products and from offering investment advice regarding such products. This would include statements regarding the lack of insurability of such products. Tellers or other employees should be able to receive a nominal referral fee that does not depend on whether the referral results in a transaction. Tellers or other employees accepting deposits should be permitted to make such referrals on a solicited or unsolicited basis with these caveats. Coast allows referral fees to be paid to non-licensed employees on a qualified referral. A qualified referral is a presentation by the licensed employee to a customer whether or not the customer invested in a nondeposit product.

These safeguards would ensure that the customer is only purchasing uninsured products or seeking investment advice on such products from qualified or properly trained sales representatives, while affording the institution some reasonable opportunities to cross-market products to their customers.

Compensation Standards

Section 44(f)(4) would require the federal banking agencies to prescribe regulations to ensure that compensation programs do not provide incentives for the sale of unsuitable products.

An approach to address these concerns is contained in the industry guidelines. The guidelines state that "compensation for the sale of nondeposit investment products should be structured to avoid incenting the sale of unsuitable products. DSRs [designated sales representations] should be free to offer customers a choice of investment products that provide different levels and types of compensation. For example, compensation may be commensurate with the amount invested, the duration of the investment, and the income generated to the bank by the investment. However, DSRs should not favor or disfavor the sale of a particular investment company, group of investment companies, or insurance company product based solely on the receipt of brokerage commissions or other incentives." This is consistent with Coast's compensation program.

Product Names

Section 44(g) would prevent an institution from using its name, title, or logo in a common or similar fashion with the name, title or logo of the investment company for which the institution or its affiliate acts as investment advisor, or with a nondeposit investment product. This restriction would not apply until six months after the date of enactment of the legislation. After that period, the institution could continue to use a name for the product that is common or similar to its own if the appropriate federal banking agency determines, in writing, that the use of such a name would not mislead any person as to the uninsured nature of the nondeposit investment product.

If the depository institution shares a name that is similar to its own, the operational distinction between entities and products should be disclosed in all presentations, in all marketing and promotional material, and on the customer acknowledgment form. The institution may wish to consult with its counsel regarding the possibility of misleading customers in cases of similar names with other entities or products. It would also make good business sense for the institution to consult with the appropriate federal banking agency to determine whether the institution is deemed to have proper safeguards in place to avoid customer confusion regarding the responsibilities of the separate entities.

Use of Customer Information

Section 44(h) would prohibit a depository institution from disclosing any confidential customer information either directly or indirectly to any person, including an affiliate of the institution, without the prior written consent of the customer. The customer information needed in the ordinary course of business would be excluded from this disclosure prohibition.

Respecting the privacy of customers should be an essential component of any program for selling uninsured products. Only limited information should be available to sales representatives or others involved in the marketing of uninsured products. Cross-marketing can be effectively combined with customer privacy. The industry guidelines limit such information to the name, address, telephone number, and types of insured and uninsured products previously purchased. This information would be needed in any customer profile used for determining suitable products for the customer. The guidelines state that other customer information should be used only with the appropriate notice to the customer and the customer should have the opportunity to object to the disclosure. The institution's compliance program should regularly monitor the use of customer information. Institutions are also urged to consult applicable state and federal requirements regarding the privacy of consumer information.

Managerial Controls and Compliance Procedures

Section 44(i) would require the federal banking agencies to review the depository institution's compliance with the various sections of the proposed legislation when conducting any examination. The institution would have to ensure that third-party employees comply with the provisions contained in H.R. 3306. This subsection also includes a Sense of Congress proviso that the federal banking agencies use testers to monitor compliance with the various provisions in the proposed legislation.

The industry guidelines and the interagency policy statement devote significant attention to the institution's and its board's oversight of the uninsured product sales program, including third-party vendor agreements. The industry guidelines specify that the oversight program should be in writing and should address the investment product selection process for the institution and its customers and the allocation of responsibilities among parties involved

directly or indirectly in the sales effort. SCBA is urging its members to require third-party vendors to adopt the provisions in the industry guidelines appropriate to their activities.

The guidelines state that a proper oversight program should designate which types of investment products the institutions will sell and what policies and procedures will govern the marketing of the products. In making these determinations, the oversight program should consider product rankings by nationally recognized statistical rating organizations and the financial condition and stability of the investment product and its provider. The institution should designate specific supervisory personnel to supervise, review, and endorse transactions in accounts handled by sales representatives and to approve the opening of new accounts. Supervisory personnel should meet and interview sales representatives at least annually. Agreements with third-party vendors should be periodically reviewed and provisions should be included in vendor agreements giving the institution this authority.

The industry guidelines note that an acceptable compliance program should be independent of the investment product sales and management activities. Safeguards should be in place to verify compliance with all applicable laws and regulations and a system should be established to monitor customer complaints. Spot checking of uninsured product accounts should be utilized and appropriate corrective actions implemented immediately. Finally, the institution should have policies and procedures to avoid violations of federal insider trading laws.

Coast has written policies and procedures regarding the sale of nondeposit investment products which have been board approved. These policies and procedures are currently being reviewed and revised using the industry guidelines. All revisions will be presented at the next board meeting for approval. Coast regularly examines both the product provider and the third-party marketing organization for compliance, stability, terms and conditions, and servicing needs. Each Investment Specialist is required to keep customer files in the branch which contain copies of applications, certificates of disclosures, acknowledgment forms, financial inventory forms and other required forms. The branch files are scheduled to be audited once a year.

This concludes my review of H.R. 3306. Let me assure the Subcommittee that Coast will remain vigilant to ensure proper consumer awareness of the risks associated with investing in uninsured products and that proper investment recommendations are made to customers. The industry guidelines should help other savings institutions achieve these same objectives.

Off-the-Page Prospectuses

I would like to turn my attention now to a proposal under consideration by the SEC that would alter the competitive balance between depository and nondepository institutions that offer mutual funds. This proposal would also undermine a consumer's ability to fully understand the risk exposure in investing in mutual funds.

The SEC is proposing to permit consumers to invest in shares of mutual funds through advertisements ("off-the-page prospectuses") and an order form without face-to-face contact with any sales representative. This authority is grossly inconsistent with any reasonable standard for consumer protection. While insured depository institutions, by their very nature, should be subject to high standards of consumer awareness when selling uninsured products, there is no reason that securities brokerage houses should be able to sell these products with lax disclosure requirements.

There is no conceivable version of an off-the-page prospectus that will enable potential investors, both experienced and inexperienced, to fully understand and compare the financial implications of alternative mutual fund investments. Investors now have a choice of waiting for a section 10(a) prospectus or speaking with a sales agent before making an investment. A section 10(a) prospectus explains technical investment concepts such as cumulative total return, average annual total return, adjusted net asset value, and portfolio turnover rate. For less experienced investors who do not read or cannot understand a complex prospectus, the ability to discuss investment alternatives with a sales agent before fund share purchases provides such an investor with a comprehensive picture of investment alternatives and the extent to which a particular mutual fund satisfies the individual's broader investment strategies and objectives.

Conclusion

The self-policing activities of the industry and the supervisory vigilance of the regulators should ensure that uninsured products are being sold with the best interests of the consumer in mind. SCBA is committed to doing its part in reviewing, on an on-going basis, the progress of savings institutions in implementing the industry guidelines, and would be pleased to share its findings with the Subcommittee.

Mr. Chairman, this concludes my prepared remarks. I would be happy to answer any questions you may have.

ATTACHMENT I

All advertising, sales materials and promotional materials provided by Coast Federal Bank contain the following disclosure:

> Coast Fed Investments & Insurance is a division of Coast Fed Services, a subsidiary of Coast Federal Bank. Securities, including variable annuities are offered solely through FIMCO Securities Group Inc., member NASD and SIPC. Annuities and securities are not obligations of or guaranteed by Coast Federal Bank. Annuities and Securities involve investment risk, including fluctuation in value and possible loss of principal, and return on investment is not guaranteed. Annuities and Securities are not FDIC-insured.
>
> FIMCO SECURITIES GROUP INC., IS THE REGISTERED BROKER/DEALER

All brochures for uninsured products either have this disclosure printed on them or a sticker with this disclosure is placed on the material prior to distribution to customers. All sales presentations must disclose that these products are not FDIC-insured nor are they bank deposits, obligations of, or guaranteed by Coast Federal Bank, and they involve possible investment risk including loss of principal. This disclaimer is verified at the time of an investment by having the customer read and sign an acknowledgement form. Coast has two separate disclosure forms - one for fixed annuities and one for mutual funds (see Attachments II and III). Any time an additional investment is made into a mutual fund, a new disclosure form must be signed by the customer. Currently, for fixed-rate annuities, Coast requires a disclosure only at the time the account is opened, not for subsequent investments. We are currently reviewing this policy for possible revisions.

ATTACHMENT II - COAST FED MUTUAL FUNDS ACKNOWLEDGMENT

INVESTMENT ACKNOWLEDGMENT & RECEIPT

FSG Account No.

Client's Name (Last, First, Middle Initial)	Joint Client's Name (Last, First, Middle Initial)

Fund Name	$ Amount

_______% As a front end sales charge which will be deducted from principal at the time of purchase.
_______% As a maximum deferred sales charge which will be deducted at redemption unless I hold my investment for the number of years specified in the prospectus.

Distribution Instructions(Choose one)
- ☐ Reinvest all distributions in same fund
- ☐ Remit dividends in cash, reinvest capital gains
- ☐ Remit all distributions in cash

Mutual Fund Special Instructions
- ☐Issue Certificate ☐Systematic Withdrawal Plan*
- ☐LOI/ROA*$________________________
- ☐Send distribution to third party address*

☐New ☐Existing – Fund Account No.____ *Requires Fund Application

1. **I acknowledge that I have received, and have had the opportunity to review a PROSPECTUS from my Registered Representative; it contains important information about my investment.**
2. **My investment is made available by Registered Representatives of FIMCO SECURITIES GROUP, INC., a registered broker/dealer and not by Coast Federal Bank where purchased. Coast Federal Bank is not a broker/dealer or an affiliate of FIMCO Securities Group, Inc. Investments are not deposits and are not FDIC insured, nor are they obligations of Coast Federal Bank.**
3. My investment is long-term in nature and the principal value may be higher or lower when I redeem my shares or units depending on the market value of the securities in the Mutual Fund, Unit Investment Trust, or Variable Annuity portfolio(s) at that time. **Dividends, yields, and overall rate of return will fluctuate. Past performance is not a guarantee of future results.** I understand that while I can sell my investment at anytime, because of the sales charge, it is not appropriate for short-term needs.
4. **Government Share and Unit Values are not Guaranteed.** Although payments of principal and interest on underlying U.S. Government Securities are guaranteed to the Mutual Fund, Unit Investment Trust, or Variable Annuity portfolio(s), the market value of the shares or units will fluctuate.
5. **A sales charge applies to my purchase as indicated above and in the prospectus.**

In Addition to items 1-5 above, the following apply to Variable Annuity purchases

6. If I choose to cancel within the prescribed ten days after the receipt of the contract, I understand that while the deferred sales charge will be waived, my investment will be subject to market fluctuation and I may receive back less than I paid depending on the market value at the time of cancellation.
7. Withdrawals from tax deferred annuities prior to age 59 1/2 are subject to a federal income tax penalty of 10%.

By signing below, I acknowledge that the Registered Representative has explained and I have read and understand items 1 through 5 above. In the event I have purchased a variable annuity, I also acknowledge that the Registered Representative has explained and I have read and understand items 6 & 7.

Client's Signature	Date
Joint Client's Signature	Date
Registered Representative's Signature/Number	

For Office Use Only

Order Placed With	Time of Order	Date	Point of Sale-State Order Taken in California
Funds Payable to			☐Wire Order ☐Subscription Order

Coast Fed Investments & Insurance 04-05
White/FSG Yellow/CFI &I Pink/Branch Gold/Client

ATTACHMENT III - COAST FED FIXED ANNUITIES ACKNOWLEDGMENT

COAST FED
INVESTMENTS & INSURANCE
A Division of Coast Fed Services

Certificate of Disclosure

This is to certify that ______________________________ has purchased a tax-deferred annuity underwritten by ______________________________, a legal reserve company.

The following applies to my annuity:

- It is not insured by the Federal Deposit Insurance Corporation (FDIC).
- It is not an obligation of or guaranteed by Coast Federal Bank. My principal and interest are guaranteed by the underwriting insurance company.
- It offers liquidity of funds at all times; however, surrender penalties for early withdrawal will be assessed. I should refer to my policy for the schedule applicable to my specific annuity.
- There are no additional charges or annual maintenance fees.
- 100 percent of my funds earn interest from the first day the policy takes effect.
- It offers various guaranteed income options.
- The interest I earn accumulates tax-deferred until I begin taking withdrawals.

As with all annuities, if I withdraw my funds prior to age 59½, I may be subject to a federal tax penalty.

______________________________ ______________________________
Applicant Applicant

I certify receipt of $______________________ given to purchase a tax-deferred annuity.

______________________________ ______________________________
Date Agent

CFS 3703 12 91 WHITE - CFI&I. CANARY - Branch; PINK - Customer 93N-001 (20M) 12/91

ATTACHMENT IV - COAST FED CUSTOMER FINANCIAL INVENTORY

CONFIDENTIAL FINANCIAL INVENTORY

OWNER: Last Name, First Name	Account Number

GOALS/OBJECTIVES

How long have you been banking here?	Do you own or rent your home? ☐Own ☐Rent

What is your most important financial goal?

Have you established an emergency fund? _____Yes _____No

If yes, which account?

REQUIRED FOR ANNUITY INVESTMENTS:

Approximate Annual Income	Net Worth	Tax Bracket	Investment Objectives
☐Under $20,000 ☐$40,000-49,999	☐$0-150	☐15% ☐36%	☐Growth ☐Income
☐$20,000-29,999 ☐$50,000-59,999	☐$150-300	☐28% ☐39.6%	☐Tax Deferred Income
☐$30,000-39,999 ☐$60,000-75,000	☐$300-500	☐31%	☐Tax Free Income
☐Other_____	☐$500+	☐Other_____	☐Asset Accumulation

Investment Experience	Investment Risk
☐Stocks ☐CDs ☐Bonds ☐Mutual Funds	☐Conservative: Maximum safety of principal even if it means lower returns
☐Money Market ☐Fixed Annuities ☐Variable Annuities	☐Moderate: Some risk is acceptable for reasonable rate of return
☐Other_____	☐Aggressive: Highest possible return and growth potential, even with a greater degree of risk

BANKS AND SAVINGS & LOANS

Name	Account Type	Account #	Maturity Date	Int Rate	$ Amount

INVESTMENTS - Stocks, Bonds, Mutual Funds, Variable and Fixed Annuities, & Life Insurance

Investment Name	Date Acquired	Initial Investment	Current/Cash Value	Income

SIGNATURES:

Customer's Signature: Date

Customer's Signature: Date

Agent's/Registered Representative's Signature & Number Date

08/93 White/FSG Yellow/CFI & I Pink/Branch Gold/Client

Testimony

of the

Consumer Bankers Association

before the

Subcommittee on Financial Institutions
Supervision, Regulation and Deposit Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

on

Bank Mutual Fund Activities

March 8, 1994

Mr. Chairman and members of the Subcommittee, my name is Thomas P. Johnson. I am Chief Retail Banking Executive at Barnett Banks, Inc., Jacksonville, Florida. I am also Chairman of the Consumer Investments Committee of the Consumer Bankers Association ("CBA") and am also a member of its Government Relations Council. I appreciate the opportunity to appear before the Subcommittee on behalf of the CBA to testify on bank mutual fund activities.

The CBA was founded in 1919 and represents approximately 750 federally insured banks and thrift institutions holding more than 80 percent of all consumer deposits. Since CBA focuses on retail issues, its membership includes regional, superregional, and money center banks, a majority of which offer investment products to their customers.

You have asked us to describe the involvement of the banking industry in the sale of mutual funds, what action the banking industry is taking to assure adequate disclosure to bank customers of the risks associated with purchasing mutual funds, and what further action, if any, should be taken by the federal bank regulatory agencies or Congress. We are happy to be able to address these questions before you.

MUTUAL FUNDS ARE AN IMPORTANT PART OF THE BUSINESS OF BANKING

Mr. Chairman, mutual funds have become an important part of the business of banking. Similarly, banks have become an important part of the business of mutual funds. Mutual funds are the fastest growing investment product offered by banks, and bank related mutual funds have become the fastest growing segment of the mutual fund industry.

Since the beginning of 1992, an avarage of $1 billion of new money has flowed into mutual funds each business day. The mutual fund industry is two-thirds the size of the banking, thrift, and credit union industries combined, with over $2 trillion in assets. At year-end 1992, an estimated 27 percent of U.S. households owned shares of mutual funds, up from six percent in 1980. Today, the amount of U.S. dollars invested in mutual funds equals or exceeds the amount invested in deposits.[1]

It has been reported that banks accounted for one-third of all new sales of money market funds and 14 percent of all new sales of long-term funds in the first half of 1992. Moreover, about one-third of all mutual

[1] Much of the available data regarding bank mutual fund activities has been compiled by the Investment Company Institute, and we would like to acknowledge the ICI's valuable contribution in this ragard.

funds were available through banks. These figures undoubtedly increased for 1993.

Many banks act as investment advisers to mutual funds which they make available to their customers. Approximately 113 banks currently offer these so-called proprietary funds with over $200 billion in assets. Chairman Levitt of the Securities and Exchange Commission recently testified that, during the past five years, bank proprietary mutual funds grew from 213 portfolios with $35.4 billion in assets to 1,156 portfolios with $194.7 billion in assets and that bank-managed funds comprise almost one quarter of all mutual fund portfolios.

These figures show that mutual funds have become virtually mandatory for those commercial banks that wish to provide a full line of financial services to their retail customers and remain competitive in today's financial marketplace.

When one considers the benefits of investing in mutual funds, the dramatic growth of this industry is easy to understand. Mutual funds offer the smaller investor the advantages of professional investment management, increased diversification, enhanced liquidity, daily valuation, and protection against market risk through modern hedging techniques.

Retail customers increasingly are looking to their local banks for mutual funds and other investment services, and it is not hard to understand why. Banks are a convenient delivery channel for obtaining all types of financial services. No other type of financial service provider offers such an extensive delivery network. Banks are located everywhere, from residential urban markets to small rural towns with many offices from which the customer can choose. The convenience of obtaining a wide range of financial services at a single location is no small benefit for today's busy retail investors.

Banks also tend to be not only more accessible but more approachable than brokerage firms. Banks meet the financial needs of all types of consumers, not just the sophisticated affluent investor. With our experience in dealing with the broader market and the delivery system to back us up, we offer the majority of consumers a more accessible way of obtaining mutual funds and other investment products. Without banks, many consumers would be deprived of these products and services and would go unserved. As the primary financial institution for a wider customer base, bank participation efforts in mutual funds will help in the process of educating all investors on the advantages and disadvantages of these products.

The consumer clearly has chosen mutual funds as a preferred investment option. In our business, we consistently see the consumer make good decision after good decision, whether it be refinancing in a low interest rate environment or shifting investments when returns are below acceptable levels. We believe selling mutual funds through banks adds convenience and additional product options to the consumer.

Customers at Barnett who chose to invest in our mutual funds over the past year were exposed to greater risk than an insured deposit, but they also earned a much better return in comparison to our customers who chose to stay with an FDIC-insured CD. The following illustrates this comparison. In 1993, Barnett customers had an average of almost 200 million dollars in three of the mutual funds we make available (Equity Fund, Government Bond Fund and Florida Tax Exempt Municipal Bond Fund). These customers earned an average return, after commission, in 1993 of 10 percent. By comparison, our average one year CD annual percentage yield in 1993 was approximately 3 percent. Customers investing in our funds earned an additional 7 percent which translates into approximately an additional 14 million dollars compared to investing in Barnett's one-year CD.

Moreover, banks are well-equipped to offer mutual funds. They have expertise to evaluate different

investment products, to assess the investment profile of the customer and match it with an appropriate investment, to execute purchase and redemption transactions, and to comply with all applicable laws. Banks have been providing these services to their trust customers for years. Moreover, banks routinely invest in mutual funds for their own accounts. Mutual funds are a natural complement to the products and services that banks have offered for years.

The world of investing is changing dramatically for the consumer and change creates some confusion. We believe that we are well suited to serve our customers well through this evolution.

BANK MUTUAL FUND ACTIVITIES ARE PART
OF THE FINANCIAL SERVICES EVOLUTION

It is important to understand that the growth of bank mutual fund activities is only one element of a larger evolution of the financial services industry. The mutual fund industry itself is a product of an evolution over the past two decades that has transformed the nation's financial services markets.

Although the first U.S. mutual fund was created in 1924, the mutual fund industry's dramatic growth has occurred in more recent times. From 1975 to 1993, the number of mutual funds increased from 426 to over 4,000 and total assets in mutual funds increased from $46

billion to over $2 trillion. In the 1970's through the mid-1980's, this growth was due largely to the introduction of the money market mutual fund which offered checking account features and market interest rates and was viewed by many bank customers as an attractive substitute for a bank checking account. In the inflationary environment of the late 1970's, these funds lured billions of dollars away from banks and thrifts that were subject to a statutory prohibition against payment of interest on checking accounts and regulatory ceilings on the amount of interest payable on savings deposits.

After the elimination of interest rate ceilings, mutual funds remained an attraction for investors eager to participate in the rising stock market of the 1980's. Moreover, the aging of the baby boom generation has created a tremendous need for savings and retirement investment vehicles. Changes in the law governing employee benefits now favor self-directed employee contribution plans where, unlike traditional defined benefit plans, each employee makes his own investment decision. Mutual funds are ideally suited for this purpose by providing the small investor with access to expert investment management, lower transaction costs, diversity of investment risk, and a high degree of liquidity.

Mutual funds now are available to retail customers from a variety of sources, including securities brokerage firms, insurance companies, and other companies and associations, as well as banks. For example, General Electric Co. has its own mutual fund family called the "GE Funds." The American Association of Retired Persons also offers its members a family of mutual funds sponsored by Scudder called the "AARP Funds."

The growth of bank mutual fund activities reflects the blurring of distinctions between different types of financial institutions as a result of technological innovations and competitive factors. The traditional role of commercial banks as financial intermediaries has been substantially eroded as prime corporate customers have directly accessed the financial markets by issuing commercial paper and other debt and securitizing their assets.

Nonbank competitors increasingly perform services that once were available mainly from banks, including issuing consumer credit in the form of credit cards and automobile loans and making home mortgages. These competitors effectively are acting like banks without being subject to the bank regulatory framework. Many brokerage firms offer an insured savings account component as part of their investment products, usually

through brokered CDs. An article in the Washington Post recently pointed out the purported benefits of asset management accounts offered by nonbank brokerage firms, equating them with bank checking accounts:

> "Investors with at least $5,000 in cash or securities should ask themselves whether they really need a bank account. The asset-management accounts offered by many brokerage firms can cover most--perhaps all--of the services you need." When you open an asset-management account, you typically get: (1) A money-market fund. It serves as an interest-paying checking account but with higher rates than you would earn at a bank. (2) A debit card. Like checks, debit cards pay for purchases by authorizing withdrawals from your account. (3) A margin account, which lets you borrow against the security of the stocks or mutual funds you own. (4) A brokerage account. Any interest, dividends or capital gains are swept into your money-market account. (5) A single monthly statement showing all your financial transactions."[2]

Viewed in this light, it is clear that bank mutual fund services are only a small part of a general merging of the financial services markets that has already occurred.

This development has been beneficial not only in affording consumers more convenient access to a wide variety of investment products at competitive prices, but to the banks themselves in the form of service income. Mutual fund services, along with other new products and services, have become an important source

---

2 "Asset Management Account Might Fill Your Banking Needs," Washington Post, H3, Feb. 27, 1994.

of replacement revenue for the decreasing bank revenues from lending activities. Banks earn service income not only by providing investment advice, brokerage, and shareholder services to their retail mutual fund customers, but by providing services to mutual funds directly, including managing the fund's portfolio and providing administrative, custodial, or transfer agent services.

CONCERNS ABOUT CUSTOMER CONFUSION

The rapid growth of the mutual fund industry and the increased availability of mutual funds to retail consumers has given rise to serious concerns about customer confusion. Several recent surveys show a disturbing lack of education and awareness in the general population as to the risks and uninsured nature of mutual funds sold not only through banks but nonbank mutual fund providers as well. The surveys also indicate a high degree of confusion about the nature of SIPC insurance. Interestingly, one survey also shows a surprising lack of awareness as to the availability of FDIC insurance for deposit products.

The surveys suggest that much of the confusion about mutual funds relates to money market mutual funds. These funds invest primarily in highly liquid short-term investments such as U.S. government securities and do

have a consistent record of safety and stability comparable to insured deposits. Since they were introduced more than twenty years ago, no investor in such a fund has ever lost money. It is quite possible that the surveys may have confused these funds with money market deposit accounts (so-called "MMDAs") that are offered by banks which are FDIC insured.

With respect to equity stock funds, customers appear to generally understand that these funds can fluctuate in value and carry a significant risk of loss of principal. With respect to bond funds, however, there is less understanding of the relationship between the value of the fund's shares and the movement of interest rates. More education clearly is needed from all fund providers to help consumers better understand the risks involved in these funds.

Two recent surveys have been used to support arguments that customers who buy mutual funds at their banks are not adequately informed that these investments do not carry FDIC insurance. A closer examination of these surveys shows that they do not provide sufficient evidence to reach this conclusion.

SEC Chairman Arthur Levitt released an SEC-sponsored survey of 1,000 households and told the Senate Banking Committee last November, and repeated to the House Energy and Commerce Committee March 2, that a key

finding is that 66 percent of bank mutual fund holders agreed with the statement "Money market mutual funds sold through banks are federally insured."

A closer examination of this survey, and a separate survey commissioned jointly by the American Association of Retired Persons ("AARP") and the North American Securities Administrators Association ("NASAA"), could lead to different conclusions.

Of the sample of 1,000 demographically representative households in the SEC survey, three-quarters said they were the principal financial decision-maker (PFD). Of those, 378 said they were not mutual fund holders and 370 said they owned mutual funds. Of those owning funds, only 70 said they own mutual funds sold through banks or S&Ls.

Thus, only 70 households, or seven percent, said they had brought mutual funds through a bank. A less emphasized finding was that 84 percent of the bank mutual fund customers agreed with the statement, "You can lose money in a money market mutual fund," suggesting that customers are aware of market risks associated with mutual funds.

If you read the actual numerical results of the survey, some other surprising facts emerge. First, the respondents were better informed about the lack of

federal insurance of mutual funds sold in bank branches than they were about mutual funds sold by brokers elsewhere. A full 34% of brokers' customers believed that mutual funds are federally insured while only 25% of those surveyed believed that mutual funds sold in bank offices are federally insured.

The numbers for money market funds may reflect a confusing question in the SEC's survey as much as anything else. Forty-five percent of persons surveyed thought that money market funds sold in banks are federally-insured, yet only 25% of those same persons thought that mutual funds sold in banks are federally insured, and only 15% of those same persons believed that they could not lose money on money market mutual funds. What we may have here is confusion created by the form of the question, with some consumers thinking the survey question had to do with bank money market deposit accounts which are in fact insured by the FDIC.

A second survey was commissioned jointly by AARP and NASAA, and covered 1,000 financial decision makers who presently have a relationship with a commercial bank. Out of these 1,000 decision makers, only six percent said they had personally purchased mutual funds at their banks.

Those six percent were then asked "Can you remember who initially advised you to invest in the

mutual fund account at your bank? Was it a bank teller, a bank officer, a personal financial advisor, someone else, or is this something you decided to invest in on your own?" The responses were:

2	Bank teller
15	Bank officer
6	Other bank employee (volunteered)
14	Financial advisor
6	Other
41	Own decision
16	Don't know

This same six percent was later asked, "Did your bank give you any written disclosure concerning your mutual fund, or any material that describes the risk of this kind of investment?" The responses were:

85	yes
10	no
5	don't know

Then this six percent was asked, "Did you read the material your bank gave you?" The responses were:

86	yes
11	no
3	don't know

This survey did not report information on how many of those six percent believed that mutual funds were FDIC insured. It did report information on how many of the total sample of 1,000 thought mutual funds sold at their bank were covered by FDIC insurance, but this information is not really relevant.

The survey also resulted in some curious facts. The survey evidences a serious lack of education among

those surveyed as to the availability of FDIC insurance for bank deposit products. For example, of the 80 percent of respondents who knew that their bank offered money market deposit accounts, nearly one-half did not know that the account was FDIC insured, including 10% who said that the account was not insured. Similarly, of the 92 percent who knew that their bank offered certificates of deposit, nearly one-third did not know that such deposits are FDIC insured. Although all of the respondents knew that their bank offered checking accounts, 21 percent did not realize that the accounts are protected by FDIC insurance.

The AARP/NASAA survey also points to a high level of confusion regarding the availability of other insurance programs for mutual funds and securities. In response to the question, "As far as you know, is there any other insurance program that protects the value of [your account] at your bank?", 40 percent thought there was other insurance for mutual funds, 36 percent thought so for stocks, and 48 percent thought so for government bonds. These results suggest that there is at least as much confusion regarding SIPC coverage as FDIC insurance.

Notwithstanding these results, 82 percent of the respondents in the AARP survey said that it was easy to understand the different fees and rates their bank

charges for services, 75 percent responded that it was easy to understand the financial risks involved in making different kinds of investments through the bank or didn't know, and 75 percent responded that the rules and regulations that apply to different accounts and services offered by the bank were easy to understand.

These surveys indicate an immediate need for banks and other mutual fund providers to enhance their training and education programs regarding mutual funds, as well as the various other investment products available in the financial markets generally, including deposits.

I would like to add a note here about the parallels that have been drawn between bank sales of mutual funds to retail customers and Lincoln Savings and Loan's sales of uninsured notes of its parent company to customers. When Lincoln Savings failed, those customers lost all of their money. In sharp contrast to the Lincoln Savings situation, however, mutual funds hold broadly diversified portfolios of securities of many different issuers. The failure of any one company has only a relatively small impact on the value of a mutual fund. The mutual fund cannot own securities issued by the bank that is the adviser to the mutual fund or by any affiliate of that bank. If Lincoln Savings had sold its customers mutual funds, those customers most likely

would still have their money today. The failure of Lincoln Savings would have had absolutely no effect on the value of its customers' mutual fund shares.

BANK MUTUAL FUND SALES PROGRAMS
EMPHASIZE CUSTOMER PROTECTION

The reports of customer confusion regarding mutual funds and other investment products have sounded a loud alarm within the banking industry. We recognize the need for heightened attention to customer protection and consumer education and we are responding to this need quickly and comprehensively.

Of all the financial service providers that offer mutual funds to retail customers, banks have adopted among the most thorough internal policies and procedures relating to consumer protection. Over the past year, the industry has developed extensive policies and procedures regarding retail sales of mutual funds. These policies and procedures seek to minimize customer confusion, to fully disclose the risks inherent in mutual fund investments, to ensure that mutual fund investments are suitable for the needs of individual investors, to provide proper training and supervision of sales personnel, and to ensure that compensation programs are properly structured to protect customers. These policies and procedures are reviewed and approved by the bank's board of directors.

In an unprecedented effort, the CBA and five other banking trade associations have jointly developed comprehensive guidelines for their respective member institutions engaged in retail sales of investment products. These guidelines are set forth in the booklet attached to my testimony. As you can see, the guidelines cover in great detail such matters as location of sales, the setting and circumstances of sales, disclosures, advertising and marketing, suitability, employee qualifications and training, employee compensation and referral fees, bank management and board of directors oversight, arbitration, and considerations for selecting third party providers and investment products to be offered to customers.

The banking industry guidelines are intended to complement the mutual fund guidelines developed by the federal bank regulators and to assist banks in complying with applicable regulatory requirements. The guidelines emphasize the need to view customer interests as paramount in all aspects of mutual fund sales programs and demonstrate the banking industry's commitment to a high level of customer protection. They place a strong emphasis on oral and written disclosure and on other ways to help customers understand the uninsured nature of mutual funds and to make intelligent and suitable mutual fund investments.

Never before have the banking trade associations united in such a proactive effort to guide the conduct of banking activities. The CBA and its sister associations view this effort as critical to ensuring the protection of investors in the interests of furthering the long-term health of both the banking industry and the mutual fund industry.

To help the Subcommittee understand the extent of the banking industry's consumer protection effort, we thought it would be useful to provide a step-by-step description of the mutual fund sales process that banks are expected to undertake under applicable rules and agency directives. The sale of mutual funds (both proprietary and nonproprietary) in the retail offices of banks typically is conducted as follows:

When a customer in a bank office expresses an interest in mutual funds, the customer is referred to a trained and qualified investment specialist (not a teller) for information regarding mutual funds. The investment specialist is trained and qualified to sell mutual fund products and frequently is a series 6 or 7 registered representative of an NASD member. The customer is directed to a desk identified as a place where noninsured investments are sold, away from the area of the bank in which tellers accept deposits. The investment specialist orally tells the customer that

mutual funds are not insured by the FDIC, are not deposits or other obligations of the bank nor guaranteed by the bank, and that mutual fund shares are subject to investment risks, including possible loss of the principal amount invested by the customer. These disclosures are also included on signs at the desk location.

If the customer is still interested in mutual funds, the investment specialist gives the customer the forms necessary to open a mutual fund account and seeks information regarding the customer's financial situation and degree of investment experience, investment goals, risk tolerance, and other factors relating to the suitability of the investments for the customer. The investment specialist reviews this information with the customer and determines what types of investments may be suitable for that customer. Based this information, the investment specialist may recommend a particular mutual fund or group of funds to the customer.

The investment specialist gives copies of the mutual fund prospectus to the customer to read. The prospectus describes the key features of the mutual fund and provides the information that the SEC requires to be given to the customer. On the cover page of the prospectus in prominent type face there should be a statement that the shares of the fund are not deposits

or obligations of, or guaranteed by, the bank, are not insured by the FDIC or any other government agency, and that share value may fluctuate.

The investment specialist offers to help the customer to understand the key features of the mutual fund that are described in the prospectus, including the risks involved, the fees involved and the types of assets that the mutual fund invests in. If the bank or an affiliate of the bank is the fund's investment adviser, this fact is disclosed.

If the customer is interested in purchasing shares of the mutual fund, the customer places an order with the investment specialist and gives him or her a check for the purchase price. The investment specialist gives the customer a disclosure form to be signed by the customer stating that the customer understands that shares of mutual funds are not insured by the FDIC, are not deposits or other obligations of the bank nor guaranteed by the bank, and are subject to investment risks, including possible loss of the principal amount invested by the customer. The investment specialist forwards the customer's order and check to a supervisory office, together with the account form, suitability questionnaire and signed disclosure form.

Trained and qualified supervisory personnel review the suitability questionnaire to determine

whether the particular mutual fund is appropriate for that particular customer's situation. If so, the order is forwarded to the mutual fund, which opens an account for shares in the customer's name and mails a confirmation to the customer of the purchase of the shares. The confirmation generally includes the required disclosures, as does the periodic account statement sent to the customer.

While this is meant to be a general description, you can see that a number of check points are built into the process to avoid the sale of unsuitable investments to retail bank customers and to otherwise address the potential for customer confusion. We believe that our disclosures on the risks of mutual fund investments and the required customer acknowledgment statement go well beyond what is required in the brokerage industry, particularly in disclosing the lack of FDIC insurance.

BANK MUTUAL FUND ACTIVITIES ARE HIGHLY
REGULATED UNDER BANK AND SECURITIES LAWS

It is important to understand that banks engage in mutual fund activities within an extremely comprehensive regulatory and supervisory framework. We have often said that banking is the most highly regulated industry in the United States, and this is certainly true with respect to bank mutual fund activities.

The statutory bank regulatory framework applicable to bank mutual fund activities includes the National Bank Act, the Bank Holding Company Act, the Federal Reserve Act, and Federal Deposit Insurance Act, the Bank Supervision Act, and the FDIC Improvement Act of 1991, among others. These laws include prior approval and notice requirements, minimum capital requirements, restrictions on affiliate transactions, insider transactions, restrictions against anticompetitive practices, and public benefit standards, among many other regulatory provisions.

Bank mutual fund activities also are subject to extensive regulation under the federal securities statutes, including the Investment Company Act of 1940, the Securities Act of 1933, and the Securities and Exchange Act of 1934, among others.

The federal banking regulators have extensive resources to monitor and enforce compliance with these laws. Banks that engage in mutual fund activities are subject to frequent periodic examination. Federal law requires the federal banking agencies to conduct a full-scope, on-site examination of each insured bank not less than once during each 12 month period, or every 18 months for very small well capitalized banks. Federal bank examiners are permanently located on-site in large banks all day, every day, year round.

All of the federal bank regulators have intensified their examination focus on bank mutual fund activities. The OCC recently added a lengthy new section to the Handbook for National Bank Examiners setting forth detailed guidance for examiners to follow in reviewing bank mutual fund retail sales operations.

The high degree of banking supervision was noted by SEC Chairman Levitt who, in comparing it to the SEC's resources, stated that "[e]ven though the investment company industry is two-thirds the size of bank, thrift and credit union assets, the entire Commission had only 260 staff for its 1993 investment management program compared to almost 21,000 staff available for the oversight of banks, thrifts and credit unions."[3]

Federal banking regulators have a host of enforcement tools to ensure compliance with the laws applicable to bank mutual fund activities. Under the Bank Supervision Act, an agency can initiate an administrative enforcement proceeding if the agency believes that the institution or an institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe is about to engage, in an unsafe or unsound practice or violation of

---

[3] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Nov. 10, 1993.

a law, rule, or regulation, or written condition imposed by the agency.

Depending upon the severity of the offense, the banking agency can force the bank immediately to stop the unsound practice or violation, impose fines of up to $1 million per day for the violation, make the bank fire the responsible persons, ban the responsible persons from the industry for life, and force the bank to correct the conditions that resulted from the violation and adopt procedures designed to ensure that it will never happen again. The federal banking agencies can take immediate action without hearing if the situation warrants, or can go through an administrative process within the agency to force compliance. The federal banking agencies are not shy about using these enforcement powers.

Under FDICIA, a banking regulator can downgrade a well-capitalized bank and apply the applicable prompt corrective actions authorized under FDICIA if it determines that the bank is engaged in an unsafe or unsound practice.

The ability of the banking regulators to enforce compliance with the mutual fund guidelines has been questioned since the guidelines are not rules or regulations. As noted above, however, the enforcement powers of the banking regulators extend to unsafe and

unsound practices as well as violations of rules and regulations. I doubt that the federal regulators would hesitate to declare as an unsafe or unsound practice a bank's sale of mutual funds without any disclosure that the fund shares are not FDIC insured, for example. Moreover, the federal regulators are highly skilled in obtaining compliance with regulatory "guidelines" even though they are not technically "regulations."

There appears to be a misperception that bank mutual fund activities are not subject to the protections of the federal securities laws. While the federal securities laws defer to the federal banking agencies to provide regulation in certain areas, bank mutual fund activities in fact are highly regulated by both the SEC and the federal banking agencies under the securities laws.

All mutual funds sold by banks are distributed by broker-dealers that are regulated and examined by the SEC and NASD. All mutual funds sold by banks are required to be registered with the SEC under the Investment Company Act of 1940, unless they qualify for the limited exemptions that are generally available. Shares of bank-sold mutual funds are required to be registered with the SEC under the Securities Act of 1933. The 1940 Act contains a number of complex, substantive requirements relating to the operation of

mutual funds. As a general matter, the 1940 Act is designed to protect investors by regulating the operations of the mutual fund and the relationship between the mutual fund and the firms that provide services to the mutual fund. The 1933 Act is primarily a registration and disclosure statute. The content of prospectus disclosures, advertising, marketing materials and other communications to potential purchasers of mutual fund shares through banks is heavily regulated under the 1933 Act.

While banks are exempt from broker-dealer registration under the Securities Exchange Act of 1934, it is important to realize that they are not exempt from the Act's antifraud provisions. The antifraud provisions prohibit false or misleading statements in connection with the offer or sale of a security, including a mutual fund. This means that all advertising or marketing materials relating to mutual funds may not contain untrue statements or any statements that, while true, might tend to be misleading. In addition, the anti-fraud provisions impose an affirmative obligation to disclose information that would be important to a potential investor in making an investment decision.

The SEC has a powerful arsenal of enforcement powers to remedy violations of the applicable securities

laws by banks. The SEC is authorized to investigate any person or firm (including a bank) suspected of violating the federal securities laws or SEC rules adopted under the laws. It can issue cease and desist orders against any person (including a bank) whenever it believes the securities laws have been or are about to be violated, and can seek monetary penalties on securities law violators, including banks.

Certain of the provisions of the federal securities laws create private rights of action in the event of a violation, including the anti-fraud provisions of the securities laws that apply to banks. In addition, fraud in the sale of securities is a "predicate offense" under the Racketeer Influenced and Corrupt Organizations Act ("RICO") which authorizes private suits to collect treble damages. Wilful violation of the federal securities laws by a bank can result in criminal penalties.

The banking agencies also enforce the securities laws that apply to banks. The Comptroller of the Currency has issued a "Securities Activities Enforcement Policy" which states:

> The OCC has the power to institute enforcement proceedings under the federal securities laws and 12 U.S.C. 1818 for violations of the federal securities laws. . . . Actions may be based on violations of 12 C.F.R. Part 16, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the

> Investment Advisers Act of 1940, the Trust Indenture Act of 1939, and other laws regulating the securities activities of national banks.[4]

The Policy states that the OCC will use formal securities enforcement actions in cases involving violations of the antifraud provisions of the federal securities laws, misuse of customer funds or securities, customer abuse, other deceptive or unfair practices, serious and/or repetitive violations of law, significant internal controls breakdowns, or the existence of a likelihood of future violations.

In furtherance of competitive equality and consistent with SEC practice, the OCC has stated that administrative enforcement actions relating to securities activities of national banks will be made public at their inception, unless the OCC determines that it is in the public interest that such a proceeding be private.

As you can see, bank mutual fund activities are subject to extremely comprehensive supervision and regulation under both the federal banking and securities laws.

---

[4] OCC Securities Activities Enforcement Policy (PPM-5310-5 (Rev.) July 7, 1993). A copy of the Policy is attached to this testimony.

FURTHER TRAINING AND COMPLIANCE EFFORTS
CLEARLY ARE NEEDED BY ALL INDUSTRY SEGMENTS

Notwithstanding the extensive securities and banking law framework applicable to mutual fund activities, additional compliance efforts clearly are needed.

While we believe that the problem of customer confusion will diminish as banks and other mutual fund providers implement consumer protection policies and procedures, the reports of customer confusion indicate that we must carefully to monitor the effectiveness of our efforts and take additional steps where needed.

Additional efforts being recommended by the banking industry include:

-- intensified training programs for bank personnel and supervisors in branch offices;

-- enhanced senior management oversight of bank mutual fund sales programs;

-- consumer surveys by individual banks to ascertain the source of customer confusion;

-- self-testing programs involving "secret shoppers" and after sale follow-ups with customers who purchase mutual funds; and

-- education programs and seminars to advise customers about market movements and cycles that may affect their mutual fund investments.

To the extent that customer confusion results from the sales activities of third party broker-dealers operating on bank premises, banks are required by the industry and regulatory guidelines to adopt appropriate

contractual provisions to ensure that these vendors comply with the guidelines as well as other applicable rules and regulations. Banks also will need to carefully select the third party brokers which they allow to operate on bank premises.

In order to ensure that the consumer protection and compliance measures adopted by the banking industry are effective, it will be important for other segments of the mutual fund sales industry to also address customer confusion and adopt appropriate measures to educate consumers and improve customer understanding of the risks and uninsured nature of mutual funds. The SEC and other surveys show that customer confusion is a significant problem with respect to mutual funds sold by nonbank service providers. Moreover, the insured savings account that some brokerage firms offer as a component of their investment products could be confusing to some customers. To the extent that nonbank providers, such as the American Association of Retired Persons (AARP), are competing with banks for the same customers, we believe that they should consider adopting similar disclosures and other consumer protection measures.

We are proud of the record of banks in providing mutual fund services to their customers. We are continuing to work with individual banks, our sister

trade associations and members and federal banking regulators to ensure that problems of customer confusion are minimized to the greatest extent possible in the future.

To the extent that problems of customer confusion about mutual funds arise at institutions other than banks, we believe that they need to be addressed by the appropriate securities or insurance company regulators and relevant industry trade associations. We would be pleased to share our regulatory experience and ideas with these groups if it would be helpful to them in fashioning similar protections.

ADDITIONAL LEGISLATION IS NOT NEEDED AT THIS TIME

In view of the extensive regulatory framework that already applies to bank mutual fund activities, as well as the proactive initiatives undertaken by the industry and its regulators, the CBA does not see a need for legislation to further address bank mutual fund activities at this time. The regulatory apparatus for ensuring that bank mutual fund activities are conducted in a safe and sound manner with due regard for consumer protection already exists and is working. Any legislation to impose rigid statutory requirements would only stifle the healthy evolution of bank mutual fund regulation as well as the ability of banks to offer new

mutual fund products and services within existing regulatory bounds.

You have asked us to comment specifically on H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act. The bill addresses a wide range of matters, including misleading practices, disclosure requirements, signed customer acknowledgments, advertising and promotional materials, location of sales, sales through ATMs, the role of deposit taking employees, training of sales personnel, compensation standards, names of bank mutual funds, and confidentiality of customer information. All of these matters are addressed in the mutual fund guidelines issued by the bank trade associations and federal regulators.

Speaking for the CBA, I will tell you that we made a conscious effort to address the concerns reflected in H.R. 3306 when we drafted the trade association guidelines. While we did not adopt the bill's provisions in all of their exact detail, we attempted to follow the general regulatory direction of the bill. The appendix to my testimony includes a comparison of H.R. 3306's provisions with the industry and bank regulatory guidelines.

In view of the extensive regulatory initiatives taken by the industry and the bank regulatory agencies,

we feel it would be premature for Congress to adopt legislation in this area at this time. Although the industry and regulatory agencies have been developing their mutual fund guidelines over the past year, the new guidelines were published only last month. The regulatory and supervisory process needs an opportunity to work. If it turns out that additional or different measures are needed to ensure the safe and sound conduct of bank mutual fund activities, the bank regulators have flexibility under existing law to impose new measures. The CBA and other industry groups have pledged to work with their members and the bank regulators in this regard. We recognize that the health of the banking industry depends on the health of our customers, and we intend to take all customer protection measures necessary to minimize confusion among bank customers who seek the benefits of mutual fund investments.

Mr. Chairman, thank you for this opportunity for us to testify on this important matter.

APPENDIX

Comparison of H.R. 3306 with Industry and Federal Bank Regulatory Mutual Fund Guidelines

On February 1, 1994, the Consumer Bankers Association and other banking trade associations issued guidelines for banks engaged in retail sales of mutual funds and other nondeposit investment products ("Industry Guidelines"). The other trade associations are the American Bankers Association, The Bankers Roundtable, Independent Bankers Association of America, National Bankers Association and the Savings & Community Bankers of America. On February 15, 1994, the Federal Reserve Board, FDIC, Comptroller of the Currency, and Office of Thrift Supervision issued an Interagency Statement on Retail Sales of Nondeposit Investment Products ("Interagency Statement").

This memorandum compares the Industry Guidelines and the Interagency Statement with the provisions of H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act.

1. SCOPE OF COVERAGE

H.R. 3306. The bill generally applies to mutual fund sales in banking offices that are commonly accessible to the general public for the purpose of accepting or withdrawing deposits. The bill generally does not apply to mutual fund sales to sophisticated customers. Certain provisions of the bill apply to third parties who sell mutual funds on behalf of a bank.

Industry Guidelines. The Guidelines apply to domestic retail sales of mutual funds to individuals by or through any FDIC-insured institution. The Guidelines apply to sales (including marketing and promotional activities) by employees of the bank as well as by affiliates and third parties that sell mutual funds to the bank's customers on or through the bank's premises. The Guidelines cover sales resulting from telephone or written communication initiated from the bank's premises, or resulting from a solicitation of bank customers. Not covered are sales to sophisticated customers and fiduciary

accounts which are subject to applicable fiduciary laws.

Interagency Statement. The Statement applies when retail recommendations of mutual funds are made by bank employees, employees of a third party (affiliated or not) occurring on the premises of the bank (including telephone sales or recommendations by employees or from the bank's premises and sales or recommendations initiated by mail from its premises); and sales resulting from a referral of retail customers by the institution to a third party when the bank receives a benefit for the referral. The Statement does not apply to the sale of mutual funds to nonretail customers, including fiduciary accounts administered by a bank.

2. PROHIBITION ON MISLEADING PRACTICES

H.R. 3306. The bill prohibits an insured depository institution from permitting any person in a bank-related sale to engage in any practice that could mislead or "otherwise cause a reasonable person to reach an erroneous belief with respect to" the uninsured nature or investment risk associated with a mutual fund or other nondeposit investment product. The federal banking agencies are required to prescribe rules of fair practice governing retail sales by phone and direct mail solicitation and are directed to take into account the Rules of Fair Practice of the National Association of Security Dealers (NASD).

Industry Guidelines. This prohibition is implicit throughout the Industry Guidelines and is addressed as well in the anti-fraud provisions of the securities laws that are applicable to banks and their employees. The Guidelines state that they "are intended to work in tandem with" the applicable rules of the SEC and NASD. As noted above, the Guidelines apply to retail sales by banks and their employees that result from a telephone call or written communication initiated from the premises of the bank.

Interagency Statement. This prohibition is implicit throughout the Industry Guidelines and is addressed as well in the anti-fraud provisions

of the securities laws that are applicable to banks and their employees. As noted above, the Interagency Statement applies to sales resulting from telephone or written communication initiated from the premises of the bank.

3. DISCLOSURE REQUIREMENTS

H.R. 3306. Any person who offers mutual funds for sale in any office of or on behalf of an insured depository institution must disclose in writing that the product is not FDIC insured and poses some investment risk which may involve the loss of principal such that, when the product is sold, it may be worth less than when purchased by the investor. A visual or oral notice may be provided through the ATM device in lieu of written disclosures, other than in the case of an initial purchase.

Industry Guidelines. Customers should be informed both orally and in writing at the time of account opening or initial purchase mutual funds are not bank deposits, are not obligations of or guaranteed by any bank, are not insured or guaranteed by the FDIC or any other government agency, and involve investment risk, including the possible loss of principal. Written disclosures should be conspicuous and prominent, appropriately placed and in appropriate style and size of type so that they will not escape the customer's attention. For example, disclosures are not conspicuous and prominent if they are lost in the middle of a multi-page document or if they are in a type-face that is too small relative to the other typefaces used in the document. The Guidelines note that the NASD has suggested that its members readvise their customers annually that mutual fund shares purchased through banks are not deposits and are not FDIC-insured.

Interagency Statement. Disclosures should specify at a minimum that the product is not FDIC insured, is not a deposit or other obligation of or guaranteed by the depository institution, and is subject to investment risks, including possible loss of the principal amount invested. The written disclosures should be conspicuous and presented in a clear and concise manner.

Depository institutions may provide any additional disclosures that further clarify the risks involved with particularly nondeposit investment products.

4. RELATIONSHIP WITH INVESTMENT ADVISER

H.R. 3306. The customer must be given a clear description of the relationship between the insured depository institution and any other person which originated the product or is otherwise directly or indirectly involved with underwriting, selling, or distributing the product. If the product is a mutual fund, the institution's relationship with the fund must be disclosed.

Industry Guidelines. If the bank or a bank affiliate is an adviser to the mutual fund, the bank should orally disclose to the customer the nature of the advisory relationship. A bank that sells shares of a mutual fund advised by the bank or an affiliate should disclose in writing to the customer that

- the bank or an affiliate acts as adviser,
- the bank or affiliate receives compensation from the mutual fund for the advisory services, and
- although the mutual fund is advised by the bank or affiliate, investments in the fund are not obligations of or guaranteed by the bank.

The existence of other material relationships between the bank or an affiliate and the fund should also be disclosed in writing. These written disclosures may be satisfied through mutual fund prospectus delivery.

Interagency Statement. Where applicable, the bank should disclose the existence of an advisory or other material relationship between the bank or an affiliate of the bank and a mutual fund whose shares are sold by the bank and any material relationship between the bank and affiliate involved in providing mutual funds. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be

disclosed. These disclosures should be made prior to or at the time an investment account is opened to purchase these products.

5. SIGNED CUSTOMER ACKNOWLEDGMENT

H.R. 3306. Any person involved in a bank-related sale of mutual fund or similar product must obtain, at the time of initial purchase, a signed customer statement that the customer has received, read, and understood the required disclosures. The statement must be on a paper separate from a written application or other document.

Industry Guidelines. At the time of investment account opening or initial purchase of mutual funds, banks should ask the customer to sign a written acknowledgment form stating that the customer has read and understands the written disclosures and any sales charges or other applicable fees or charges. The Guidelines include a sample form of written acknowledgment which states:

- The investment products I am purchasing are not bank deposits and are not obligations of, or guaranteed by, any bank. These products are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

- I have received a current prospectus and understand the sales charges and other applicable fees or charges as disclosed in the prospectus.

- Sales charges and other applicable fees or charges regarding other investment products purchased have been disclosed.

- I understand that the investment products purchased are subject to investment risk, including possible loss of principal.

- Although payment of principal (at maturity) and interest on securities in U.S. government funds is guaranteed to the fund, the market value of the shares will fluctuate with rising or declining interest rates.

- An investment product's past performance should not be considered an indication of future results.

- Procedures for redeeming, surrendering or selling my investment may vary, depending on the investment selected, and have been disclosed.

- The investment products I am purchasing ARE/ ARE NOT insured by the Securities Investors Protection Corporation ("SIPC"). SIPC coverage is not the same as the federal deposit insurance provided by the FDIC. It does not protect investors against a decline in the market value of securities. SIPC generally protects customers against the physical loss of securities if the broker-dealer holding the securities for the customer fails.

Copies of the signed form are given to the customer, the branch office, and the central office.

Interagency Statement. A statement, signed by the customer, should be obtained at the time a customer account is opened, acknowledging that the customer has received and understands the disclosures.

6. ADVERTISING AND PROMOTIONAL MATERIALS

H.R. 3306. All advertising and promotional materials and sales confirmation notices and periodic statements relating to mutual funds must contain the required disclosures.

Industry Guidelines. Advertising and promotional materials must be accurate and not misleading and must contain conspicuous and prominent notice of the required disclosures. The Guidelines include standards for conspicuous disclosure and address joint advertising or marketing of deposit and nondeposit investments. The Guidelines give examples of acceptable and unacceptable advertisements. The Guidelines also provide a list of SEC and NASD rules that govern mutual fund advertising and recommend that any

advertising and promotional materials be reviewed by bank management or counsel or, where appropriate, counsel to the mutual fund or broker-dealer.

Interagency Statement. The sale or recommendation of mutual funds should occur in a manner that assures that the products are clearly differentiated from insured deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured deposits are understood.

7. LOCATION OF SALES

H.R. 3306. No insured depository institution may permit any part of its banking offices to be used for the sale or giving of investment advice with respect to any mutual fund or nondeposit investment product, unless the area is physically segregated from the part of the office where deposits are accepted or withdrawn. A notice is required to be posted conspicuously in the segregated area stating that area is devoted to the sale of nondeposit investment products and that deposits are not accepted at that location.

Industry Guidelines. Sales of nondeposit investment products that occur in a bank should, to the extent permitted by space and personnel considerations, take place in areas that are physically separate and/or distinct from routine retail deposit-taking activities regardless of whether the sales are made by bank employees, an affiliated broker-dealer, or a third-party broker-dealer. Any area designated as the investment sales location, including a new account area, should be clearly and prominently identified with signs and/or displays that distinguish this area from routine retail deposit-taking functions. The Guidelines give examples of appropriate signage and separation. Written policies governing sales that occur or are initiated on bank premises should take into account in general terms the location(s) within the bank at which these transactions will occur.

The Guidelines note that, if sales of nondeposit investment products are conducted by a registered broker-dealer, the area of the bank in which the sales occur may have to be registered with the NASD, depending on the type and extent of activities being conducted.

Interagency Statement. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place to minimize customer confusion.

8. ROLE OF DEPOSIT TAKING EMPLOYEES

H.R. 3306. Bank employees who accept deposits from the public at any office of the bank could not give investment advice on any nondeposit product but could, upon customer request, refer customers to the appropriate sales personnel, provided that the deposit-taking employee does not solicit the request for referral, discloses that the product is non-FDIC insured, and does not receive any referral compensation.

Industry Guidelines. Employees while acting as tellers should be prohibited from selling nondeposit investment products and from offering investment advice regarding such products. Tellers may refer customers to the appropriate location and/or individual in the bank for the sale of nondeposit investment products. Tellers may respond to customer questions regarding general procedures for purchasing nondeposit investment products from the designated sales representative. Tellers are prohibited from discussing the merits of particular investment products. Mutual funds should be sold only by qualified personnel (for example, properly trained bank employees, registered

representatives, or licensed annuities salespersons). Investment advice should be given only by qualified, and if required, licensed personnel. Designated sales representatives who are bank employees may, in connection with exercising their suitability responsibilities, sell customers an insured deposit product, as appropriate. Bank employees generally may, where permitted by state law, perform ministerial and clerical functions related to investment product sales, including referring potential customers to the designated sales location or representative. They may assist prospective customers in completing account applications and forwarding paperwork. Informational brochures or materials may be distributed to potential customers. Other examples are given. If it is customary for bank personnel to wear name tags, the name tag of the designated sales representative should also indicate his or her title, such as "investment specialist," "investment counselor," or "investment representative." Dual employees should have business cards identifying them as bank employees and as employees of the broker-dealer, if applicable.

Interagency Statement. In no case should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

9. QUALIFICATIONS OF SALES PERSONNEL

H.R. 3306. No person involved in bank-related sales of mutual funds may provide investment advice on nondeposit investment products in any part of the bank or on behalf of the bank unless such person is registered with the SEC as a broker, representative of a broker, or investment adviser or meet qualification and training requirements that the banking agencies determine

are equivalent to those applicable to such a registered person.

Industry Guidelines. Bank management, designated sales representatives, and audit and compliance personnel involved with the bank's investment product program should demonstrate competence appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures. Background checks for all new sales personnel are strongly recommended. Designated sales representatives should obtain an appropriate NASD license, such as Series 6 or 7, when appropriate and possible. An NASD license equivalency certificate may also be appropriate. Bank management, sales, audit, and compliance personnel and other bank employees should be offered training appropriate to the function or responsibilities assigned to them. Training should cover product knowledge, operational concerns, sales and advertising practices, compliance and regulatory issues, disclosure, and suitability and ethical considerations. Continuing education requirements ultimately adopted by the securities and insurance industries should also be adopted and modified, as necessary, by the banking industry.

Interagency Statement. Personnel who are authorized to sell mutual funds or to provide investment advice with respect to such products should be adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of customer protection requirements. If bank personnel sell or recommend mutual funds, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives. Bank personnel with supervisory responsibility should receive training appropriate to that position. Training also should be provided to bank employees who have direct contact with customers to ensure a basic understanding of the institution's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to customer referrals. Training should be updated

periodically and should occur on an ongoing basis. Banks should investigate the backgrounds of employees hired for their mutual fund sales programs, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

10. SUITABILITY

H.R. 3306. Training of sales personnel shall include training in making an accurate judgment about the suitability of a particular nondeposit investment product for a prospective customer.

Industry Guidelines. The suitability requirements in the NASD's Rules of Fair Practice apply to registered broker-dealers. A suitability standard consistent with the NASD's Rules should apply in all cases where investment advice is offered to bank customers. Designated sales representatives have an obligation of fair dealing under the general antifraud provisions of the federal securities laws and shall observe high standards of commercial honor and just and equitable principles of trade. Sales personnel should have reasonable grounds for believing that the recommendation is suitable for the customer based on the facts, if any, disclosed by the customer as to his or her other security holdings and as to his or her financial situation and needs. Except in when a money market mutual fund is sold, sales personnel shall make reasonable efforts to obtain information concerning the customer's financial background, tax status, personal and financial situation, investment objectives, tolerance for risk, and other similar information. Sales personnel should consider risk diversification in making recommendations. Unsolicited transactions and transactions for customers seeking discount brokerage may be executed without regard to suitability if so directed by the customer. The Guidelines provide examples of practices that are inconsistent with the principle of suitability.

Interagency Statement. Sales personnel must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. If sales

personnel recommend mutual funds, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer based on information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. The information should be documented and updated periodically.

11. COMPENSATION

H.R. 3306. The federal banking agencies are required to establish minimum requirements to ensure that compensation programs do not operate as, or have the effect of providing, an incentive for the sale of nondeposit investment products in lieu of a more suitable investment option for the customer.

Industry Guidelines. A bank should have written policies governing commissions, referral fees, and other compensation. Suitability, not compensation, should guide sales. Banks are urged to cultivate a customer-oriented sales ethic: "If it's good for the customer, it's good for the bank." Compensation should be structured to avoid incenting the sale of unsuitable products. Sales personnel should be free to offer products that provide different levels and types of compensation, for example, commensurate with the amount invested, the duration of the investment, and income generated to the bank by the investment. Sales personnel should not favor or disfavor the sale of a particular mutual fund based solely on receipt of brokerage commissions or other incentives. Referral fees may be structured so as to encourage tellers and other employees to appropriately increase customer awareness of availability of all types of nondeposit investment products. Referral fees should not be based on the success of the referral in generating a sale. Tellers and other bank employees may be compensated based on individual or total referrals that result in

customer meetings with designated sales representatives.

Interagency Statement. Bank employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction. Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers. Bank compliance and audit personnel should not receive incentive compensation directly related to results of the mutual fund sales program.

12. MUTUAL FUND NAME

H.R. 3306. No bank or affiliate thereof may use or permit the use of the bank's name, title, or logo or any word or design that is similar to or a variation of the bank's name, title, or logo in connection with any mutual fund for which the bank or affiliate acts as investment adviser. The name restriction also would apply to any nondeposit investment product offered for sale by the bank or affiliate or by any person at the bank's office or on behalf of the bank. Common names in use at the time of enactment of the bill would be grandfathered for six months and longer if the relevant banking agency determines in writing on a case-by-case basis that such use is unlikely to mislead a customer or cause a reasonable person to reach an erroneous believe with respect to the uninsured nature of the product or the investment risk associated therewith.

Industry Guidelines. A mutual fund should not have a name that is identical to the bank's name. Banks should take steps, such as enhanced training, to minimize possible customer confusion when a mutual fund has a name similar to the bank's name or when the generic names of insured and uninsured products are similar (for example, money market mutual funds and money market

deposit accounts). The relationship, if any, between a bank and a mutual fund with a similar name should be disclosed in appropriate advertising and marketing materials.

Interagency Statement. Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the bank. Recommending or selling a mutual fund product with a name similar to that of the bank should only occur pursuant to a sales program designed to minimize the risk of customer confusion. The bank should take appropriate steps to assure that the issuer of the product has complied with any applicable requirements established by the SEC regarding the use of similar names.

13. CONFIDENTIALITY OF CUSTOMER INFORMATION

H.R. 3306. Confidential customer information may not be disclosed directly or indirectly to any person (including a separate division or affiliate) without prior written customer consent and a customer acknowledgment of such consent. The customer must be told that consent is not required as a condition to purchasing noninvestment products. This requirement would apply to any customer who, after the date of enactment, establishes a deposit, trust, or credit relationship with the bank.

Industry Guidelines. Customer information--such as name, address, telephone number, and types of products (including certificates of deposits) purchased--may be used by designated sales representatives to determine potential prospects for nondeposit investment products. Other customer information may be used with appropriate notice and customer opportunity to object to disclosure of such information. Banks are cautioned to consult applicable state and federal requirements.

Interagency Statement. Banks should develop and implement policies and procedures to ensure that mutual fund sales activities are conducted in compliance with applicable laws and regulations, some of which may address confidentiality of customer information.

14. COMPLIANCE PROCEDURES

H.R. 3306. All banks would be required to establish procedures to ensure that nonbank employees involved in bank-related sales of mutual funds comply with the above requirements.

Industry Guidelines. A compliance program, independent of sales and management, should be established. The program should be capable of verifying compliance with banking, securities, and insurance laws and regulations (when annuities are sold). The compliance function also should include a system to monitor customer complaints and to review periodically customer accounts, including spot checking, to detect and prevent abusive practices. Appropriate corrective actions should be implemented when necessary. A bank may wish to consider establishing a targeted call back program, a mystery shopper program, or some other method of monitoring compliance with the bank's policies and procedures. A bank may wish to consider building into its procedures for opening customer accounts an agreement between the customer and the bank to submit any disputes that arise to arbitration. A sample arbitration agreement is included in the Guidelines. To avoid liability under federal insider trading laws, banks should establish policies and procedures to prevent insider trading.

Interagency Statement. Banks should develop and implement policies and procedures to ensure that mutual fund sales activities are conducted in compliance with applicable laws and regulations, the bank's internal policies and procedures, and in a manner consistent with the Interagency Statement. Compliance procedures should identify any potential conflicts of interest and how they should be addressed. The procedures also should provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the government agreement with the bank. The compliance function should be conducted independently of mutual fund sales and management

activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported directly to the institution's board of directors, or to a designated committee of the board. Appropriate procedures for the mutual fund program should be incorporated into the bank's audit program.

PPM-5310-5 (Rev.)

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
Administrator of National Banks

Section: Bank Supervision

Subject: Securities Activities Enforcement Policy

TO: Deputy Comptrollers, District Administrators, Department and Division Heads, District Counsel, and all Examining Personnel.

I. PURPOSE

This issuance discusses the OCC's use of administrative enforcement authority in federal securities enforcement actions. It replaces PPM 5310-5, dated October 6, 1988. This policy is designed to provide firm, prompt, and fair action on matters involving use of OCC enforcement authority. The policy serves the additional function of ensuring protection of the investing public, compliance with applicable laws, and the safety and soundness of the national banking system. The OCC's securities activities enforcement policy is separate from the agency's general enforcement policy contained at PPM 5310-3.

This policy and these procedures are internal guidelines for the use of the OCC and do not create any substantive or procedural rights enforceable at law or in any administrative proceeding, or affect the authority of other governmental agencies.

II. POLICY AND SCOPE

A. AUTHORITY

The OCC uses a number of tools to carry out its obligations to enforce the federal securities laws as they apply to national banks and individuals who are subject to the jurisdiction of the OCC. The OCC has the power to institute enforcement proceedings under the federal securities laws and 12 U.S.C. 1818 for violations of federal securities laws. The OCC may bring actions for violations of the Securities Exchange Act of 1934 (Exchange Act) registration, reporting and disclosure provisions, and provisions governing (i) national bank municipal securities dealers, (ii) national bank government securities brokers and dealers, and (iii) national bank transfer agents. Actions may also be based on violations of 12 C.F.R. Part 16, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Trust Indenture Act of 1939, and other laws regulating the securities activities of national banks. In cases where a violation of the federal securities laws also

adversely affects a national bank's capital level, the OCC retains the right to institute Prompt Corrective Action (PCA) proceedings pursuant to its regulatory authority.

3. POLICY

The OCC's securities enforcement policy is designed to serve the following purposes, as appropriate: 1) to be preventive; 2) to be remedial/corrective; 3) to be disciplinary; and 4) to be a deterrent. These purposes are often related and are not meant to be mutually exclusive. The OCC uses a range of enforcement remedies, including civil money penalties, cease and desist orders, injunctions, censures, suspensions, bars, removals, limitations, and a variety of other remedies depending on the nature of the violation. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, 15 U.S.C. 78u-2 and 78u-3 (Securities Remedies Act), provided to the OCC new remedies for certain federal securities laws violations, including both civil money penalties and cease and desist orders. These remedies supplement existing remedies available to the OCC under the securities and banking laws.

The OCC will respond promptly and firmly to actual or potential problems or violations of law in an individual bank or group of banks, or committed by persons associated with the institution (associated person) or an institution affiliated party or parties. (An "associated person" is not necessarily the same as an "institution-affiliated party," although some overlap may exist. An "institution-affiliated party" generally encompasses a wider range of individuals.)

The OCC enforces the federal securities laws as they relate to the securities activities of national banks in a manner generally consistent with the discipline and treatment accorded similarly situated nonbank entities and their associated persons. The OCC consults, as appropriate, with other securities regulators (such as the Securities and Exchange Commission and state securities regulatory authorities), as well as self-regulatory organizations (such as the National Association of Securities Dealers) in instances in which administrative enforcement action is being considered. Consultation concerning the appropriateness of

bringing an action and the severity of proposed sanctions is consistent with the principle of comparable regulation under the federal securities laws, and is intended to ensure that remedies sought by the OCC generally are consistent with those required by other securities regulators in like circumstances, unless alternate remedies are more appropriate. The OCC may pursue enforcement actions available under federal banking laws for securities law violations, when such actions provide a more effective or efficient enforcement vehicle.

C. FORMAL ENFORCEMENT ACTIONS

The OCC will use formal securities enforcement actions in cases involving:

1. violations of the antifraud provisions of the federal securities laws, or rules promulgated thereunder;
2. misuse of customer funds or securities;
3. customer abuse;
4. other deceptive or unfair practices;
5. serious and/or repetitive violations of law;
6. significant internal controls breakdowns; or
7. the existence of a likelihood of future violations if formal enforcement action is not taken.

Formal enforcement actions also may be instituted to address other situations involving violations of the federal securities laws, including situations that result in prompt corrective action.

The OCC has the discretion to seek remedies for securities law violations under either the federal securities laws or national banking law, e.g., 12 U.S.C. 1818, depending on the circumstances of a particular case. The OCC recognizes the desirability of equality of securities law enforcement among securities regulators, but also remains mindful that, in certain circumstances, banking

law may provide the most efficient and effective means to address securities law violations.

D. PROMPT CORRECTIVE ACTION

The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, requires federal financial institution regulators to implement and enforce procedures for financial institutions to maintain minimum capital levels. National banks that do not meet such capital levels are subject to restrictions on the activities in which they may engage and other limitations. The OCC issued regulations discussing the new capital categories and procedures pertaining to PCA in 1992. See 57 Fed. Reg. 44,866 et seq. (1992), codified at 12 C.F.R. Parts 6 and 19.

In considering appropriate prompt corrective actions, the OCC may consider securities violations, including those involving unsafe or unsound banking practices or affecting capital levels.

E. MITIGATIVE FACTORS

In some instances, the OCC may wish to modify a formal enforcement action in view of the presence or absence of one or more mitigative factors. In such instances, the agency may decide to make a modified charge (or charges) or seek a lesser sanction. Among the mitigative factors to be considered are:

1. The capability, willingness, cooperation, integrity, commitment and intent of bank management, the board of directors, and/or ownership to correct the problems. The OCC will consider the extent to which meaningful corrective action has already been taken, is being taken (including, where appropriate, restitution to customers), or can reasonably be expected to be taken.

2. The absence of fraud, scienter, recklessness, or deliberate deception of the public. (The Supreme Court has in certain cases defined "scienter" as "a mental state embracing intent to deceive, manipulate or defraud." Certain courts of appeals have concluded that scienter includes recklessness.)

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
Administrator of National Banks

Section: Bank Supervision

Subject: Securities Activities Enforcement Policy

3. The gravity or extent of violations.

4. Whether, and how much, the public was exposed to risk.

5. The bank's previous compliance record and response to previous criticisms or supervisory records. In the case of an individual, a respondent's previous record and response to previous criticisms.

6. The presence of unique circumstances that might justify lesser sanctions.

The presence of any of these factors would not per se constitute a defense against any enforcement action or warrant the imposition of milder sanctions. Nor does the consideration of any of the above factors lessen the OCC's intention to pursue a vigorous securities enforcement policy to safeguard the investing public. Rather, every case shall be evaluated on its own merits before a decision is made to institute enforcement action, make a modified charge (or charges), or seek a modified sanction.

The OCC also takes mitigative factors into account in determining the amount of civil money penalty that should be assessed. Civil money penalties assessed for violations of the Exchange Act generally will be determined under the applicable categories provided in the Exchange Act, using as a guide actions taken by the SEC in comparable circumstances.

III. PUBLIC DISCLOSURE OF ENFORCEMENT ACTIONS

In order to give effect to the principle of competitive equality and in light of the practice of other agencies charged with enforcing the federal securities laws, administrative enforcement actions initiated in accordance with this issuance should be made public at their inception, unless the Comptroller, in his or her discretion, determines it is in the public interest that such proceeding be private. Thus, a Notice of Charges or a Notice of Assessment of Civil Money Penalty is public as of its filing. The result of this policy is that a federal securities enforcement action becomes public sooner than other types of OCC enforcement actions, which typically are made public just prior to hearing.

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
Administrator of National Banks

Section: Bank Supervision

Subject: Securities Activities Enforcement Policy

Similarly, pursuant to section 2547 of the Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789, 4886-88 (1990), 12 U.S.C. 1818(u), hearings on the record with respect to a notice of charges issued by the OCC in a banking enforcement action pursuant to 12 U.S.C. 1818 shall be open to the public, unless the Comptroller, in his or her discretion, determines that holding an open hearing would be contrary to the public interest. In addition, pursuant to section 913 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 1818(u), the OCC shall publicize and make available to the public any final order issued with respect to any administrative enforcement proceeding initiated by such agency under this section or any other provision of law.

The OCC is legally required to publicly disclose all final cease and desist orders, civil money penalty orders, any final orders issued after an enforcement hearing process, as well as any modification and/or termination of such orders, formal agreements, and any condition imposed in writing. Under certain limited circumstances, mandatory disclosure may be delayed for a reasonable period of time. Decisions to delay publication are nondelegated and will be made by the Comptroller or his or her designee after review by the Washington Supervisory Review Committee.

Once a month, the OCC's Communications Division will publish a list of enforcement actions that includes the name of the individual or bank involved, the type of action, the date of the action, and whether the action was by consent. The Communications Division will maintain a file of all final formal enforcement actions and will provide copies of these documents upon request.

Nothing contained above is intended to relieve a national bank of its independent obligations to make required disclosures under the various securities laws and related regulations.

IV. PROCEDURES

OCC staff who believe that they have uncovered incidents of noncompliance with the federal securities laws should make a referral setting forth the alleged incidents to the Securities,

Investments, and Fiduciary Practices Division (SIFP), along with appropriate documentation.

A. CONTENTS OF ENFORCEMENT ACTIONS

Enforcement actions should address substantive supervisory or compliance problems. Enforcement actions need not address every supervisory or compliance issue identified. However, all documents should contain clear statements regarding any prohibited or restricted activities, remedial measures to be taken, and the time in which the bank, its board of directors, or management must act. The document should clearly state what action is expected of those parties subject to the terms of the document.

B. SUPPORT FOR DECISION

Decisions about whether to proceed with an enforcement action, and about the nature and severity of the action should be fully supported in decision memorandums by the agency's enforcement staff or designee and made a part of the bank's permanent file.

C. REFERRALS

The OCC makes referrals as appropriate to the SEC and other regulatory agencies and cooperates with such agency's investigation and prosecution. The OCC will also provide the SEC or other regulatory agency with access to relevant information collected and maintained by the OCC in appropriate situations, provided that such agency agrees to maintain appropriate confidentiality with regard to any relevant OCC information.

Similarly, the OCC receives referrals from the SEC and other federal authorities of possible violations of the federal securities laws that fall under the OCC's jurisdiction. In the event of such a referral, the OCC shall take all necessary steps to maintain appropriate confidentiality with regard to the information forwarded.

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
Administrator of National Banks

Section: Bank Supervision

Subject: Securities Activities Enforcement Policy

D. TERMINATION OF ENFORCEMENT ACTIONS

1. 12 U.S.C. 1818

The OCC may terminate or modify an enforcement action brought under 12 U.S.C. 1818 whenever, in the judgment of the agency's enforcement staff, such action is consistent with the supervisory goals for the bank and the OCC. Such actions must be supported by substantial and sustained compliance with the action in place. The responsible office will fully support a decision to terminate or modify an enforcement action by decision memorandums made a part of the bank's permanent file.

2. Federal Securities Laws

Administrative enforcement actions brought under authority of the federal securities laws result either in sanctions that are self-executing, such as censures, or of a limited duration, such as suspensions for periods of less than one year, or that are ongoing in nature. Examples of ongoing sanctions include bars, the imposition of continuing obligations to institute affirmative remedial or corrective measures, or obligations to refrain from certain activities. Termination of actions taken under authority of the federal securities laws resulting in self-executing sanctions is not appropriate. However, in cases resulting in ongoing sanctions or limitations of activities, the OCC may provide relief from certain continuing obligations (e.g., by granting permission to re-enter the securities business, with certain conditions, to persons previously barred). The OCC will consider such requests on a case-by-case basis, in light of all relevant circumstances. See 17 C.F.R. § 201.29; Securities Exchange Act Release No. 11267 (February 26, 1975), 6 SEC Docket 346.

V. RESPONSIBILITIES

Each party or individual charged with responsibility under this policy shall ensure that appropriate procedures are established to ensure that the OCC's enforcement policies are applied promptly, fairly, and consistently.

The Senior Deputy Comptroller for Bank Supervision Operations has the primary responsibility to use the OCC's administrative authorities as necessary to accomplish supervisory objectives. He or she retains for all national banks the authority to initiate, negotiate, execute, modify, or terminate enforcement actions undertaken to enforce the securities laws whether or not the bank is otherwise delegated.

The Securities, Investments, and Fiduciary Practices Division is responsible for handling securities enforcement actions against delegated and nondelegated banks.

The Senior Deputy Comptroller for Bank Supervision Operations shall use the Supervisory Review Committee to advise him or her on all enforcement actions involving bank securities activities. The Director of the Securities, Investments, and Fiduciary Practices Division shall be a member of the Supervisory Review Committee for purposes of voting on securities enforcement actions.

Stephen R. Steinbrink
Senior Deputy Comptroller for
Bank Supervision Operations

HEARING ON BANK MUTUAL FUND ACTIVITIES

STATEMENT OF MATTHEW P. FINK
PRESIDENT
INVESTMENT COMPANY INSTITUTE

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND DEPOSIT INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 8, 1994

TABLE OF CONTENTS

FIGURES

PAGE

I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 4,582 open-end investment companies (mutual funds), 433 closed-end investment companies, and 13 sponsors of unit investment trusts. The Institute's mutual fund members have assets of over $1.9 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders. The Institute's members include over 800 mutual funds advised by banking organizations, accounting for over 80 percent of all bank-advised mutual funds.

I am pleased to be here today to discuss the mutual fund industry generally, the issues raised by the increased participation by banks and their affiliates in the mutual fund business and various recommendations to ensure the protection of investors in mutual funds sold through, or advised by, banking organizations.

II. EXECUTIVE SUMMARY

A. Overview of the Mutual Fund Industry

A mutual fund is a professionally managed pool of money of many investors that is invested in a wide range of stocks, bonds or money market instruments, consistent with the investment objectives of the fund. Since the passage of the Investment Company Act, the mutual fund industry has grown significantly from 68 funds in 1940 to over 4,500 funds in 1994, and from assets of $448 million in 1940 to over $2.1 trillion today. Of the $2.1 trillion in fund assets at year-end 1993, bond and income funds held $761 billion, stock funds held $749 billion and assets of money market funds totaled $566 billion.

Mutual funds are unique in that they offer redeemable securities, which permit an investor to sell his or her shares back to the fund at any time at their current net value. Current per-share values are required by law to be calculated at least daily based on the market value of the fund's portfolio securities. Per-share values change as the values of the fund's portfolio securities move up or down. Mutual fund share purchase and redemption prices are published each day in the financial sections of most major newspapers.

Mutual fund shareholders include individuals and institutions, although the majority of mutual fund assets (63.6 percent) belong to individuals. Mutual funds are a proven means for middle-income individuals and families to receive the same benefits of professional money management and diversification of investments as wealthy individuals. According to Institute data, there were

approximately 38.2 million individual mutual fund shareholders as of year-end 1992 and it is estimated that 27 percent of U.S. households own mutual funds.

Many factors have contributed to the growth of the mutual fund industry over the years. They include the capital appreciation of portfolio securities, additional purchases by existing shareholders, new products and services designed to meet changing investor needs, the growth of the retirement plan market, increased investment by institutional investors, new distribution channels and a shift from direct investment in securities to investment through mutual funds.

Perhaps the most important factor, however, is the stringent regulation imposed upon mutual funds by the Investment Company Act. Unlike the other federal securities laws, which are designed to protect investors primarily through *disclosure*, the Act imposes detailed, *substantive* requirements and prohibitions on the structure and day-to-day operations of mutual funds. The core objectives of the Act are to: (1) insure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or regulate forms of self-dealing; (4) restrict unfair and unsound capital structures; and (5) insure the fair valuation of investor purchases and redemptions. This regulatory scheme imposes a discipline upon mutual funds to which banks and other financial institutions generally are *not* subject.

B. Bank Participation in the Mutual Fund Industry

In recent years, banks and their affiliates have substantially expanded their participation in the mutual fund industry. Banking organizations are permitted to engage in a wide range of mutual fund-related activities, including serving as a fund's investment adviser and providing discount and full-service brokerage services with respect to the sale of shares of mutual funds. An increasing number of banks now manage "proprietary funds" advised by the bank or an affiliate, although both proprietary and third-party (or "nonproprietary") funds are available through bank distribution channels. Both proprietary and nonproprietary funds must register with the Securities and Exchange Commission under the Investment Company Act; securities issued by such funds must be registered under the Securities Act of 1933.

Several factors have contributed to the growing participation of banking organizations in the mutual fund industry. Banks and their affiliates view mutual funds as an extension of fiduciary and investment management services which bank trust departments have traditionally offered customers. In addition, many banks have entered the mutual fund business in order to offer their customers alternative investment vehicles. As a result, banks have come to view the income generated from offering mutual funds and other fee-based investment products as an important component of their future profitability.

Bank entry into the mutual fund business has been a positive development for the banking industry, the mutual fund industry and the public.

There are several options available to banks that wish to sell mutual funds. First, banks can sell mutual funds to customers *directly*. When banks sell mutual funds *directly*, they are *not* required to register as broker-dealers with the SEC, nor are their employees required to pass qualifying examinations administered by the National Association of Securities Dealers, Inc. (the "NASD").

Second, many banking organizations sell mutual funds through *affiliated broker-dealers*, as well as through *third-party broker-dealers* with which banks have entered into a contractual sales arrangement. Both affiliated and third-party broker-dealers are required to register with the SEC and are subject to oversight and supervision by the SEC and self-regulatory organizations such as the NASD. Thus, the many banks which advise mutual funds and offer mutual fund shares to the public through registered broker-dealers are fully subject to the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934.

However, when the federal securities laws were adopted, Congress understood that the Glass-Steagall Act barred banks from involvement in the mutual fund business. As a result, banks (but *not* broker-dealers affiliated with banks) were exempted from regulation as "broker-dealers" under the Securities Exchange Act of 1934 and as "investment advisers" under the Investment Advisers Act of 1940. In addition, the Investment Company Act failed to address potential conflicts that may arise when banks serve as investment advisers to mutual funds. While federal banking laws address certain transactions between banks and their affiliates, these provisions are primarily intended to ensure that such transactions are fair to banks. Accordingly, they do not serve to protect the interests of investors in bank-advised mutual funds.

In light of these factors, the expanding role of banks in the mutual fund industry raises a number of regulatory issues. These issues include:

- <u>The need to ensure that the interests of investors are protected when they purchase shares of mutual funds through banks and their affiliates</u>. In particular, investors must understand that mutual funds are not insured by the Federal Deposit Insurance Corporation or guaranteed by the bank.

- <u>The need to address the unique potential conflicts created when a banking organization serves as investment adviser to a mutual fund</u>. While the Investment Company Act addresses the potential conflicts that arise when any type of firm (*e.g.*, an investment adviser, a broker-dealer, an insurance company or a bank) advises a mutual fund, the Act does not address the unique conflicts that may arise when a bank performs this function.

- <u>The issuance of duplicative and inconsistent standards on bank mutual fund sales activities by the federal banking agencies</u>. Although the SEC is the primary regulator of mutual fund sales activities, current regulatory gaps have led the federal banking agencies to issue "guidelines" on bank mutual fund sales which differ from current SEC and NASD standards. These guidelines apply not only to banks, however, but also to registered broker-dealers that are already subject to SEC and NASD regulations.

- <u>The potential impact of mutual fund-related activities on the safety and soundness of depository institutions</u>. Because these issues are largely derivative of investor protection issues, mutual fund-related activities should not pose a significant threat to safety and soundness *if* appropriate SEC and NASD investor protection provisions are in place.

- <u>The extent to which current laws impose significant impediments to banks seeking to engage in the mutual fund business</u>. The Glass-Steagall Act still bars banks from sponsoring, or underwriting and distributing the shares of, mutual funds. In addition, officers, directors and employees of "member banks" (*e.g.*, banks which are members of the Federal Reserve System) may not serve as directors of a mutual fund.

The Institute believes that Congress should respond to these issues by amending the federal securities laws to require that banks conduct mutual fund-related sales activities through separate subsidiaries or affiliates subject to full regulation by the SEC. As noted above, many banks are already conducting their sales activities in this manner. Therefore, the exemption of banks from the definition of a "broker-dealer" in the Exchange Act and from the definition of "investment adviser" in the Investment Advisers Act should be repealed. Moreover, Congress should amend the Investment Company Act to include investor protection provisions which address the potential conflicts created when a banking organization serves as investment adviser to a mutual fund. *All* remaining restrictions on bank participation in the mutual fund business (*e.g.*, the restrictions on bank sponsorship and distribution of mutual funds and on common bank-mutual fund directors) should be eliminated.

Similar amendments to the federal securities laws were included in both S. 543, "The Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991," and H.R. 6, "The Financial Institutions Safety and Consumer Choice Act of 1991." The basic approach reflected in these bills was sound and merits further consideration.

The Institute believes that this approach offers the best protections to mutual fund shareholders. All participants in the mutual fund industry should be subject to the same regulation, enforced in the same manner by the single federal agency which Congress created to protect investors in securities -- the SEC. No other federal agency has this exclusive mandate and no other federal agency has comparable experience in protecting investors and administering the requirements of the federal securities laws. Over the past 50 years, the SEC has demonstrated its ability to administer the requirements of the Investment Company Act flexibly to accommodate new entrants in the mutual fund business, such as broker-dealers and insurance companies. Although the SEC has taken appropriate actions with respect to bank mutual fund activities when permitted, the remaining "regulatory gaps" in the SEC's authority should be filled.

Conversely, while the Institute applauds the investor protection goals of H.R. 3306, the Institute does not believe that Congress should perpetuate a second, duplicative regulatory system by conferring additional authority on federal banking regulators to establish investor protection standards for bank mutual fund sales activities. Congress should not require the federal banking agencies to issue new disclosure, training and compensation standards with respect to bank sales of mutual funds, when detailed SEC and NASD standards on retail sales activities already exist. Banks could -- and should -- be made fully subject to these standards through a limited number of amendments to the federal securities laws and should not be subject to a duplicative scheme of regulation under federal banking laws. Under our proposal, investors in all mutual funds would receive exactly the same protections.

III. OVERVIEW OF THE MUTUAL FUND INDUSTRY

A. General Description

Mutual funds are the most popular and well known type of investment company, representing approximately 86 percent of all investment company assets.[1] A mutual fund is a professionally managed

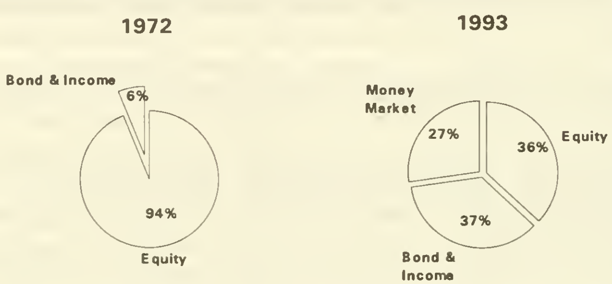
---

1 The other two types of investment companies are unit investment trusts and closed-end investment companies. Unit investment trusts own a fixed portfolio until the maturity of the trust, at which time the trust is dissolved and the proceeds are distributed to unit holders. In contrast, closed-end funds, like mutual funds, are

(footnote continued on following page)

pool of money of many investors that is invested in a wide range of stocks, bonds or money market instruments, consistent with the investment objectives of the fund. For many years, mutual funds concentrated in common stocks of American companies. As recently as 1971, 94 percent of industry assets were in equity funds. In contrast, the fund industry of the 1990s is diversified. Today funds are distributed among the three broad categories of fund types: equity funds, bond and income funds and money market funds. Of the $2.1 trillion in fund assets as of the end of December 1993, bond and income funds held $761 billion, stock funds held $749 billion and assets of money market funds totaled $565 billion.

FIGURE 1
Distribution of Mutual Fund Assets by Type of Fund
(percentages)



Mutual funds are unique in that they offer redeemable securities, which permit an investor to sell his or her shares back to the fund at any time at their current net asset value. Current per-share values are required by law to be calculated at least daily based on the market value of the fund's portfolio securities. Per-share values change as the values of the fund's portfolio securities move up or down. Mutual fund share purchase and redemption prices are published each day in the financial sections of most major newspapers.

---

managed on an on-going basis by an investment adviser. The distinguishing feature between closed-end funds and mutual funds is that closed-end fund shares are not redeemable. Instead, they are generally traded on one of the major stock exchanges or in the over-the-counter market.

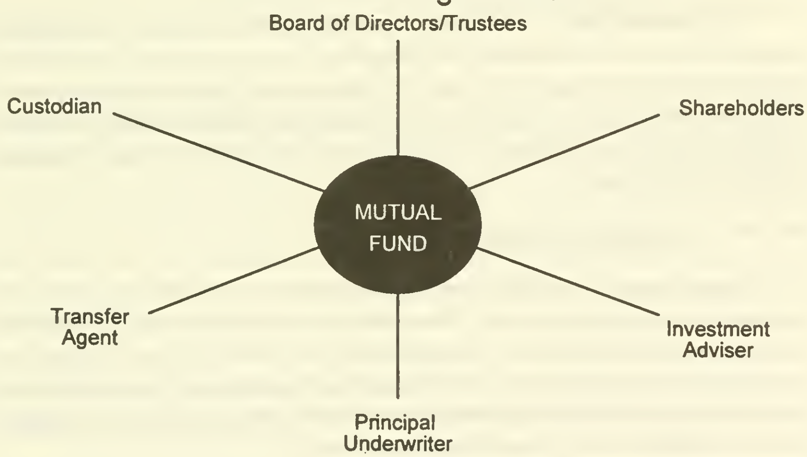
Each share of a mutual fund owned by an investor is a security representing a proportionate ownership interest in all of the fund's underlying securities. Dividends, interest and capital gains produced by these securities are paid out to investors in proportion to the number of shares owned. Accordingly, investors who invest a few hundred dollars get the same investment return per dollar as those who invest hundreds of thousands of dollars.

B. Organization And Operations

Mutual funds are generally organized under state laws as corporations or business trusts. They are usually externally managed by a separate entity, which means that they do not have employees of their own and all of their operations are conducted by third parties. The structure of a typical mutual fund organization is depicted below.

Figure 2

Mutual Fund Organization



1. <u>Board of Directors/Trustees</u>

Funds that are established as corporations have directors, while funds established as business trusts have trustees. The duties of directors and trustees are essentially identical. The role of directors

and trustees in policing conflicts of interest is central to the regulatory scheme to which mutual funds are subject. Directors and trustees are required to oversee the management and operations of the fund, to provide policy guidance, and to protect the interests of fund shareholders in conflict-of-interest situations. The heightened duties specifically imposed on mutual fund directors and trustees are in addition to those responsibilities imposed generally on corporate directors and trustees under state law.

Federal law generally requires that at least 40 percent of the fund's board of directors be comprised of persons who are not affiliated with the fund, its investment adviser, or its principal underwriter. These independent directors serve as watchdogs over the shareholders' interests and provide a check on the investment adviser and other persons affiliated with the fund. Federal law also generally provides that officers, directors and employees of a single bank may not comprise a majority of a fund's board of directors, although this restriction does *not* apply to a bank's nonbank affiliates within a holding company structure.

2. <u>Investment Adviser</u>

The investment adviser is responsible for selecting portfolio investments for the fund in accordance with the fund's investment objectives and policies. The investment adviser is usually paid for these services through a fee based on the value of the fund's net assets. Many investment advisers also provide administrative services to the fund and, for example, may oversee the activities of the other companies that provide services to the fund to assure that the fund's operations comply with applicable federal and state requirements

3. <u>Custodian and Transfer Agent</u>

Mutual funds are limited in their ability to hold their own assets and, therefore, generally place their assets in the custody of a third party. Most mutual funds use a bank custodian, whose functions include safeguarding the fund's assets, making payments for the fund's purchases of securities and receiving payments for the fund when securities are sold. The transfer agent performs shareholder recordkeeping services. It maintains shareholder account records, issues new shares, cancels redeemed shares and distributes dividends and capital gains to shareholders.

4. Principal Underwriter/Distributor

The principal underwriter (or distributor) arranges for the distribution of the fund's shares to the public. Since mutual fund shares are redeemable, most mutual funds continuously offer new shares to the public.[2] Mutual fund shares are generally purchased by investors in two ways -- they may be purchased from a member of a sales force or directly from a fund. These two distribution channels are frequently referred to as "sales force distribution" and "direct marketing," respectively. Most sales force distributed funds charge a sales commission and are commonly referred to as "load" funds,[3] whereas most direct marketed funds do not charge a commission and are thus usually referred to as "no load" funds.

C. Profile of the Mutual Fund Shareholder

Mutual fund shareholders include individuals and institutions (*e.g.*, bank trustees and other fiduciaries, business corporations, retirement plans, insurance companies and foundations). The majority of mutual fund assets (63.6 percent) belong to individuals. In addition, many institutional shareholders own mutual fund shares on behalf of individual investors, including trust beneficiaries and participants in retirement plans.

Mutual funds are a proven means for middle-income individuals and families to receive the same benefits of professional money management and diversification of investments as wealthy individuals and, therefore, have played a significant role in opening the securities markets to millions of Americans. By 1992, 27 percent of U.S. households owned mutual funds. According to Institute data, there were approximately 38.2 million individual mutual fund shareholders as of year-end 1992. These individuals had a median age of 46 years, median household income of $50,000, average financial assets (excluding real estate and assets in employer-sponsored retirement plans) of $114,000 and an average of $43,500 invested in mutual funds. Another recent survey found that first-time investors in equity and bond and

---

2 Some mutual funds stop selling new shares once their assets under management reach a certain level. One reason why funds stop selling new shares is the limited availability of the securities in which they invest (such as a sector fund investing in a particular industry).

3 Under rules adopted by the NASD, the maximum sales charge that a mutual fund may charge is 8.5 percent of the initial investment or the economic equivalent thereof. Included in the definition of "sales charge" are (i) "front-end" sales charges, which are payable when shares are first purchased; (ii) "asset-based" sales charges (commonly referred to as 12b-1 fees, after a rule under the Investment Company Act), which are taken out of a fund's assets to pay for distribution-related costs; and (iii) "back-end" sales charges, which are paid when shares are redeemed.

income mutual funds have a median age of 40 years, median household income of $55,000 and an average of $41,200 invested in equity and bond and income funds.[4]

D. Growth of the Mutual Fund Industry

1. Facts About the Industry's Growth

The first mutual fund in the United States was organized in Boston in 1924. Since the passage of the Investment Company Act of 1940, the mutual fund industry has grown significantly from 68 funds in 1940 to over 4,500 funds in 1994, and from assets of $448 million in 1940 to over $2.1 trillion today. Although media reports have implied that mutual funds suddenly "boomed" in the 1990s, fund assets also increased at a strong and steady rate during the 1980s, from $95 billion in 1980 to $1 trillion in 1990.

2. Factors Contributing to Mutual Fund Growth

a) Stringent Regulation

As described in greater detail in Section III(E), the strict regulatory scheme to which mutual funds are subject under the federal securities laws has played a vital role in the growth of the mutual fund industry. Mutual funds differ from most other public companies in that they are subject to detailed, substantive regulation at both the federal and state level. Among other things, the Investment Company Act prohibits or restricts transactions between a mutual fund and affiliated persons of the fund and requires that at least forty percent of a fund's board must be independent of the fund's adviser and principal underwriter. Furthermore, the Act requires mutual funds to sell and redeem their shares at their current net asset value, which must be determined at least daily. As a result of this regulatory scheme, there is a high level of public confidence in mutual funds.

b) Additional Purchases by Existing Shareholders

Much of the growth in the industry is due to additional purchases by existing shareholders, rather than purchases by first-time investors. While there has not been an in-depth study of this issue, the available evidence indicates that most of the "new" money invested in mutual funds is coming from persons who already own mutual fund shares. For example, between March 1991 and March 1993, there

---

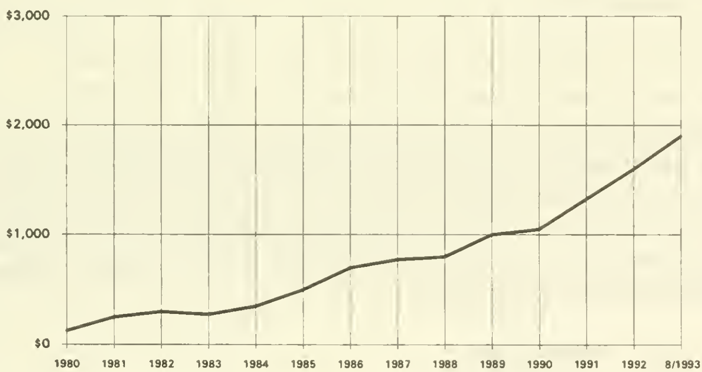
4 *Phoenix-Hecht Mutual Fund Study* (August 1993). This survey focused on individuals who made investments in equity and bond and income funds between July 1991 and July 1993.

was a 30 percent increase in mutual fund assets (not including growth attributed to capital appreciation of portfolio securities), whereas the percentage of U.S. households owning mutual fund shares increased by only about 4 percent. The small increase in the percentage of households owning mutual funds compared to the much larger increase in fund assets suggests that most of the increase in fund assets was due to additional purchases by existing shareholders. Surveys conducted by the Institute also found that only approximately 10 percent of all fund investors were first-time purchasers of mutual funds.

c) Capital Appreciation

A significant portion of the growth in mutual fund assets is attributable to the capital appreciation of portfolio securities owned by mutual funds due to increases in stock and bond prices. For example, during the period from January 1984 to July 1993, assets of equity and bond and income funds increased by approximately $940 billion, of which 43 percent was due to capital appreciation of portfolio securities and the remaining 57 percent was due to net sales of fund shares.

FIGURE 3
Growth of Mutual Fund Assets from 1980 to 1993
(billions of dollars)



d) New Products and Services

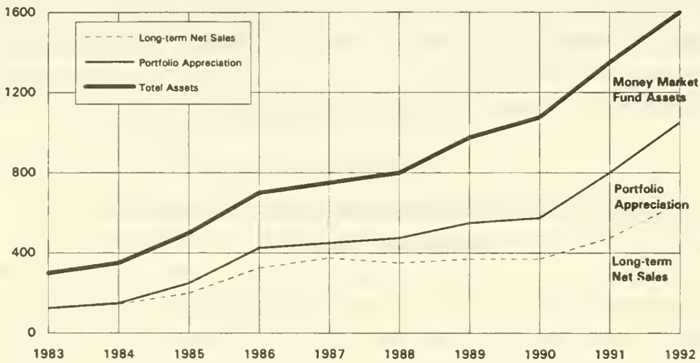
As noted above, for many years most mutual funds invested primarily in common stocks of American companies. As the needs of investors evolved over the past two decades, however, the mutual

fund industry responded by introducing new types of funds. For example, taxable money market funds were developed in 1972; tax-exempt money market funds were introduced in 1979; and the 1980s witnessed the introduction of additional types of funds, including international funds, precious metal funds, Ginnie Mae and government income funds.

FIGURE 4

Components of Mutual Fund Asset Growth

(billions of dollars)



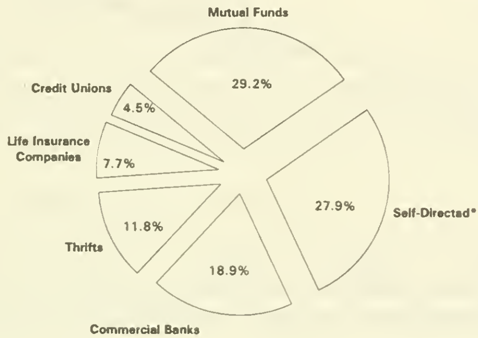
In addition, the mutual fund industry improved existing services to shareholders, as well as created many new services to meet investors' needs and expectations. Examples of such services include the introduction of toll-free (800) telephone numbers; 24-hour telephone access; touch-tone telephone access to account balance and transaction information; consolidated account statements; shareholder newsletters; shareholder cost basis information; and enhanced options for automatic investments, withdrawals and reinvestment of fund dividends.

e) <u>Retirement Plans</u>

The retirement plan market has also played an important role in mutual fund growth. Recent data reflect the popularity of mutual funds as a vehicle through which retirement plan assets are invested. By the end of 1992, retirement plan assets accounted for 23 percent of total mutual fund assets. The largest share of the fund industry's retirement plan assets are held in Individual Retirement Account

("IRA") assets. At the end of 1992, mutual funds held $211 billion, or 29 percent, of the $723.4 billion IRA market.

FIGURE 5
Shares of the IRA Market-1992
(percentages)

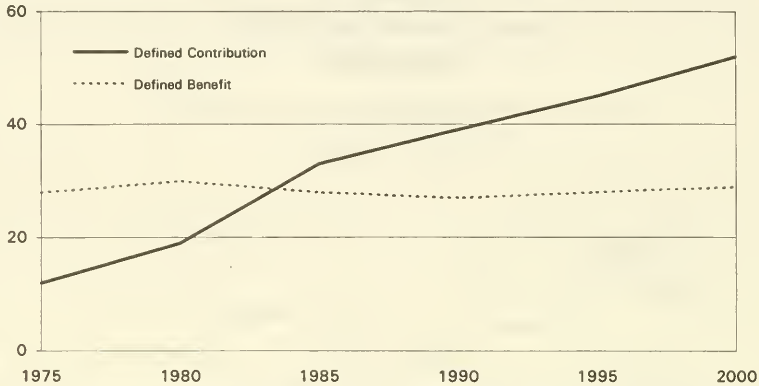


*includes only those self-directed IRAs not included in other categories; does not represent the entire self-directed universe for IRAs.

In addition, there has been a significant growth in defined contribution retirement plans such as 401(k) plans. The growth of these plans has been dramatic. In 1975, 11.2 million participants were covered by corporate defined contribution plans, as compared to the 27.2 million participants covered by corporate defined benefit plans. By 1990, however, approximately 38.1 million employees were covered by corporate defined contribution plans, compared to 28.8 million employees in corporate defined benefit plans. With their multiple investment options, daily pricing and wide range of shareholder services, mutual funds have become an increasingly popular investment medium for corporate defined contribution and defined benefit plans.

FIGURE 6

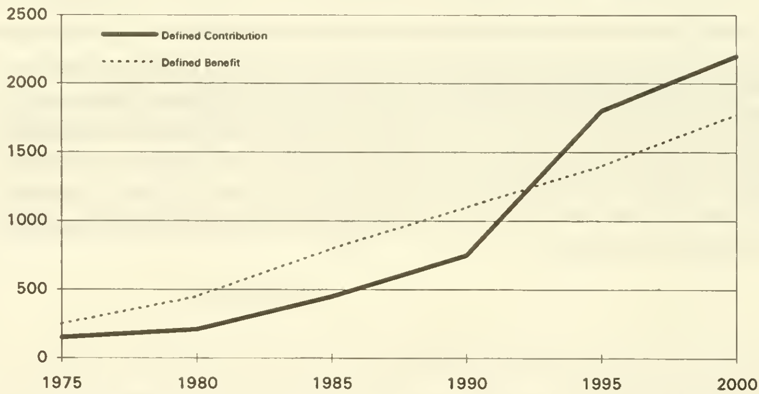
Private Pension Coverage (millions of employees)



Source: U.S. Department of Labor and Federal Reserve Board. Projections beyond 1990 were based on past trends and the outlook for the regulatory and economic environment, reflecting the views of the Department of Labor economists.

FIGURE 7

Private Pension Coverage (billions of dollars)



Source: U.S. Department of Labor and Federal Reserve Board. Projections beyond 1990 were based on past trends and the outlook for the regulatory and economic environment, reflecting the views of the Department of Labor economists.

f) Institutional Investors

While the majority of mutual fund assets belong to individuals, institutional investors (such as bank trustees and other fiduciaries, corporations, retirement plans, insurance companies and foundations) now own a significant portion of mutual fund assets. The value of institutional assets invested in mutual funds rose from approximately $1.2 billion in 1960 to $582.7 billion at the end of 1992.

g) New Channels of Distribution

Historically, mutual funds were sold primarily by full-service broker-dealers. Today, funds are offered and sold directly, as well as through a variety of additional distribution channels. These channels include insurance agents, financial planners, discount brokers and, in increasing numbers, banks and their affiliates.

h) Shift From Direct Investment

Some of the growth in the mutual fund industry is attributable to a historical trend in which investors have shifted from direct ownership of individual securities into ownership of mutual funds. This shift is due to, among other things, the attractiveness of professional management and diversification offered by mutual funds.

Articles in the media have suggested that most of the growth in mutual fund assets in recent years is attributable to bank customers withdrawing deposits, including bank certificates of deposit ("CDs"), and shifting their money into mutual funds. Federal Reserve Board data, however, indicate that the total deposits of domestic commercial banks actually *increased* from $2.3 trillion to $2.4 trillion between October 1992 and October 1993.

While yields on bank CDs in recent years have prompted some CD investors seeking better returns on their investments to shift their money into mutual funds and other securities, two recent surveys indicate that only a small percentage of holders of recently maturing CDs reinvest the proceeds in stocks and mutual funds. The first survey found that only 8 percent of such holders reinvested the proceeds in stocks and mutual funds.[5] The survey also shows that those CD holders who do move into

---

[5] *Raddon Financial Group Survey* (Spring 1993). This survey covered the six-month period preceding February 1993.

stocks and mutual funds tend to be in the higher income brackets ($50,000 and above) and have above-average holdings of liquid assets. Households in the lowest income brackets and with the smallest liquid asset holdings appear notably disinclined to shift out of CDs.[6]

The second survey indicates that 43 percent of new investors in equity and bond and income funds between July 1991 and July 1993 paid for their most recent investment in these funds from current income sources, such as bonuses, cash reserves or tax refunds. Of the 38 percent of new investors who made their most recent investment in equity and bond and income funds with the proceeds from other financial holdings, only 5 percent used proceeds from CDs.[7]

E. Regulation of Mutual Funds

1. Mutual Funds Are Subject to a Stringent Regulatory Scheme

The growth of the mutual fund industry is largely attributable to the fact that mutual funds are stringently regulated under federal and state securities laws. This regulatory scheme has fostered a high level of investor confidence. As noted by former SEC Chairman Ray Garrett, Jr., "No issuer of securities is subject to more detailed regulation than mutual funds." Mutual funds are regulated under each of the following federal securities laws:

- Shares of mutual funds must be registered under the **Securities Act of 1933**, which requires a fund to provide potential investors with extensive prospectus disclosures about the fund, including information about the fund's investment objectives and policies, investment risks, and all fees and expenses. The Securities Act also regulates mutual fund advertising.

---

6 *Id.* The study found that the median deposit level for households that intend to move out of CDs is $75,000, compared to a lower medium deposit level of $32,500 for households that intend to keep their money in CDs. This study is consistent with a recent analysis by the Securities Industry Association, which identified a substantial base (approximately $1.1 trillion) of "hard-core" time deposits which bank customers were unlikely to reinvest in alternative investment vehicles. The analysis also found that the growth in stock and bond mutual funds in 1993 attributable to outflows of CDs and other time deposits declined compared to 1992. *See* Securities Industry Association, "Investor Activity Report" (Feb. 3, 1994).

7 *See supra* note 4.

- The distributors of mutual funds are regulated as broker-dealers by the SEC under the **Securities Exchange Act of 1934**, and also are subject to regulation by the NASD.

- Investment advisers to mutual funds must register with the SEC under the **Investment Advisers Act of 1940**.

- Finally, and most importantly, mutual funds are regulated by the SEC as investment companies under the **Investment Company Act of 1940**.

In addition to regulation from the federal securities laws, Subchapter M of the Internal Revenue Code requires that a fund, among other things, meet various asset diversification tests and distribute 90 percent of its ordinary income to shareholders annually. Mutual funds also are subject to NASD requirements in connection with their distribution (sales) and advertising activities. Finally, mutual funds are regulated under state securities laws.

2. The Investment Company Act Imposes Detailed, Substantive Regulation

The Investment Company Act is a model of effective legislation, drafted by the staff of the SEC and strongly supported by the industry. At the August 23, 1940 signing ceremony, President Franklin D. Roosevelt commended this achievement, stating that "[t]he investment trusts themselves actively urged that an agency of the federal government assume immediate supervision of their activities."[8]

Unlike the other federal securities laws, which are designed to protect investors primarily through *disclosure*, the Investment Company Act imposes detailed, *substantive* requirements and prohibitions on the structure and day-to-day operations of mutual funds. The core objectives of the Act are to: (1) insure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or regulate forms of self-dealing; (4) restrict unfair and unsound capital structures; and (5) insure the fair valuation of investor purchases and redemptions.

---

[8] *See* 86 CONG. REC. 5230-31 (Aug. 26, 1940) (Statement of President Franklin D. Roosevelt). SEC Commissioner J. Carter Beese, Jr. recently noted that "starting in the 1930s, when investment companies came to government asking to be regulated, our public/private partnership has been a virtual paragon of government regulation." *See* "Mutual Funds -- America's Piggy Bank Now and . . . Forever?" Remarks of Commissioner J. Carter Beese, Jr., 1993 Mutual Funds and Investment Management Conference (Mar. 8, 1993), at 9.

In order to achieve these core objectives, the Investment Company Act establishes a strict regulatory scheme for mutual funds, which imposes a discipline upon mutual funds to which banks and other financial institutions generally are *not* subject. Thus, among other things, the Act (together with other provisions of the federal securities laws):

- strictly regulates mutual fund advertisements and sales literature and requires such materials to be submitted to the SEC or the NASD;
- provides that mutual fund investors must receive a prospectus which includes information on the management of the fund, the fund's financial performance and fees associated with an investment in fund securities;
- restricts the ability of mutual funds to issue senior securities which have priority over any other class of securities;
- prohibits or restricts transactions between a mutual fund and affiliated persons of the fund;
- requires that mutual fund officers and employees with access to fund assets be bonded against larceny and embezzlement;
- specifies stringent requirements for the custodianship for mutual fund assets;
- mandates that at least forty percent of a fund's board of directors must be independent of the fund's adviser and underwriter; and
- establishes a "mark-to-market" requirement, pursuant to which mutual funds must sell and redeem their shares at their current net asset, determined by marking fund assets to their market value at least daily.

3. <u>The Investment Company Act Provides the SEC with Broad Regulatory Authority</u>

While the Investment Company Act imposes strict controls on mutual funds, the Act has proven sufficiently flexible since its adoption in 1940 to permit the SEC to respond to new conditions affecting mutual funds. Some of the significant recent developments include:

- the adoption of amendments to the advertising rules to require the use of standardized performance data in advertisements;
- the adoption of a two-part registration statement for mutual funds to permit the use of a simplified prospectus;
- the adoption of amendments to the rules governing money market funds to tighten the restrictions on money market fund portfolios and to require disclosure that these funds are not federally insured;

- the adoption of the fee table in mutual fund prospectuses, requiring that investors be provided with a uniform, concise, straightforward summary of all fees and expenses; and

- the adoption of a rule to allow the assets of mutual funds to be maintained in foreign custody, facilitating the ability of mutual funds to invest in foreign securities.

In May 1992, following a comprehensive study of the investment company industry, the Staff of the SEC's Division of Investment Management issued a study entitled "Protecting Investors: A Half Century of Investment Company Regulation." This report generally concluded that the Investment Company Act and the regulations thereunder have worked well for the past 52 years and that there is no need for changes in the core investor protection provisions that have served mutual fund shareholders for over half a century. At the same time, the study recommended certain legislative and regulatory modernizations, most of which the Institute generally supports.

IV. BANK PARTICIPATION IN THE MUTUAL FUND INDUSTRY

A. Ability of Banks to Provide Mutual Fund-Related Services

1. Permissible Mutual Fund-Related Activities

Banks and their affiliates are currently permitted to engage in a wide range of mutual fund-related activities. These activities include: (1) serving as a fund's investment adviser; (2) providing discount and full-service brokerage services with respect to sales of shares of mutual funds; (3) offering a range of administrative services to a mutual fund, such as maintaining the fund's books and records, calculating its net asset value and filing required reports with the SEC and state securities regulators; and (4) serving as a fund's transfer agent and custodian.

The ability of banks and their affiliates to serve as investment advisers to mutual funds consistent with federal banking and securities laws was recognized by the Supreme Court over a decade ago.[9] In recent years, however, the number of proprietary funds offered to the public has grown significantly. In addition, banks and their affiliates may provide various administrative services to mutual funds. The ability of banking organizations to render such services was clarified in April 1993,

---

9 *See Board of Governors of the Federal Reserve System v. Investment Company Institute*, 450 U.S. 46, 62-64 (1981).

when the Board of Governors of the Federal Reserve System approved an application by Mellon Bank Corporation, a bank holding company, to acquire The Boston Company, a major provider of administrative services to mutual funds.[10]

2. Impermissible Mutual Fund-Related Activities

Sections 16 and 21 of the Glass-Steagall Act restrict the ability of banks to sponsor, or underwrite or distribute the shares of, a mutual fund. Pursuant to Section 20 of the Glass-Steagall Act, these restrictions also apply to nonbank affiliates of national banks and state banks that are members of the Federal Reserve System. Nonbank affiliates of state non-member banks (*e.g.*, state chartered banks that are not members of the Federal Reserve System), however, are not subject to these limitations. Under rules adopted by the Federal Deposit Insurance Corporation, "bona fide" subsidiaries of state non-member banks are authorized to underwrite and distribute shares of mutual funds, provided that certain conditions are met.[11]

In addition, the Board of Governors of the Federal Reserve Board has interpreted Section 32 of the Glass-Steagall Act to bar officers, directors or employees of any member bank from serving as an officer, director or employee of a mutual fund. The Board has stated that the ban on "interlocking" officers or directors would also apply to interlocks between a member bank and a corporation that provided investment advisory and related services to a small number of mutual funds, if the corporation was "created for the sole purpose of serving a particular fund, and its activities were limited to that function."[12]

B. Extent of Bank Participation in Mutual Fund Industry

The participation of banks and their affiliates in the mutual fund industry has increased substantially in recent years. For example, five years ago bank mutual fund sales were limited primarily to sales of nonproprietary funds. While sales of nonproprietary funds still account for the majority of bank mutual fund sales, over 100 banks offered proprietary funds by year-end 1993. According to data compiled by Lipper Analytical Services, Inc., bank proprietary fund assets exceeded $215 billion at year-end 1993, up from approximately $161 billion at year-end 1992.[13] A separate study by Cerulli

---

10 *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993).

11 *See* 12 C.F.R. § 337.4.

12 *See* 12 C.F.R. § 218.114.

13 *See* "Investment Products," AMERICAN BANKER (Feb. 9, 1994).

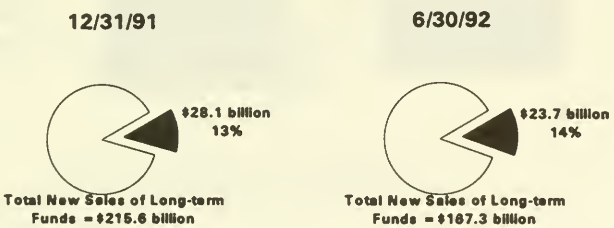
Associates, Inc. reached a similar conclusion, estimating that total bank proprietary mutual fund assets increased from $168.8 billion in 1992 to $208.6 billion in 1993.[14]

While information on the number, investment objectives and assets of bank proprietary funds has been publicly available, until recently relatively little information has been available on the assets of nonproprietary funds attributable to new sales of proprietary and nonproprietary funds through bank distribution channels. Recognizing a need to fill this information gap, the Institute undertook a comprehensive survey of bank-sold mutual funds in August 1992. Data was collected for 1991 and the first six months of 1992.[15]

FIGURE 8

New Sales of Long-term Funds Through the Bank Channel

(percent of all new sales of long-term funds)



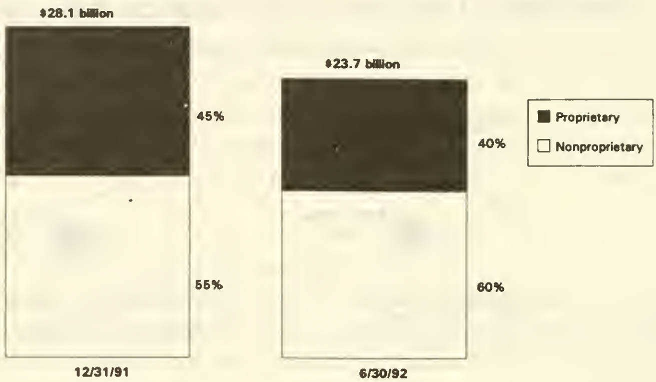
[14] *See* "Major Trends in the Mutual Fund Industry," Cerulli Associates, Inc. (Dec. 7, 1993).

[15] *See FUNDamentals*, ICI Research Department (May 1993). The Institute is currently compiling similar data for periods subsequent to the first half of 1992 and expects that such information will be available by the end of June 1994.

The Institute's study found that about one third of all mutual funds are available for sale through bank distribution channels. Nonproprietary funds accounted for approximately two thirds of funds sold through banks, with proprietary funds accounting for the remaining one third.[16] The survey also found that 13 percent of the total new sales of long-term funds (*i.e.*, equity and fixed-income funds) of $215.6 billion in 1991 and 14 percent of all new long-term fund sales of $167.3 billion in the first half of 1992 occurred through banks.[17] The assets of money market and long-term mutual funds attributable to bank sales accounted for almost 12 percent of all industry assets in both reporting periods.

FIGURE 9

Bank New Sales of Proprietary and Nonproprietary Long-term Funds



Survey respondents also indicated that most bank sales of mutual funds are made in either the retail or trust departments of banks. It is important to note that a significant portion of the sales of

---

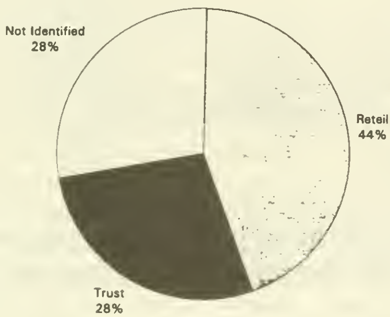
16 Most bank proprietary funds are money market funds, while most nonproprietary funds sold through banks are fixed-income funds.

17 "New sales" were defined as sales of mutual fund shares, excluding sales charges, exchanges or the reinvestment of dividends.

proprietary funds are the result of banks investing trust and custody assets under their management in their proprietary funds. A far smaller percentage of new proprietary fund assets is attributable to retail sales, including sales made to existing bank customers reinvesting the proceeds of CDs and other time deposits in mutual funds (*see* Figure 10).[18]

FIGURE 10

New Sales of Long-Term Funds Within the Bank, 6/30/92



Total Bank New Sales of Long-term Funds = $23.7 billion

18 For example, Cerulli Associates found that approximately 70 percent of new bank proprietary funds established in 1992 and 1993 were "seeded" by converting tax-exempt trust assets to mutual funds. Only 14 percent of the new proprietary fund assets were new retail assets.

The Institute's study also identified shareholders who owned at least one mutual fund purchased through a bank. This research found that such shareholders were virtually indistinguishable from other mutual fund shareholders (*see* Figure 11).

FIGURE 11

WHO IS THE BANK MUTUAL FUND CUSTOMER?

	Shareholders Owning at Least One Fund Purchased Through a Bank	All Shareholders
Median Age (in years)	46	46
Median Income	$50,000	$50,000
Average Financial Assets *	$105,000	$114,000
Average Financial Assets in Mutual Funds	$48,200	$43,500
RESPONDENT CHARACTERISTICS		
Female **	48%	44%
College Degree or More	40%	50%
Employed Full-Time	64%	66%
Retired	26%	24%

* Excluding real estate and assets in employer-sponsored retirement plans.
** Refers to household's primary financial decisionmaker or codecisionmaker.

Other research on bank mutual fund activities is generally consistent with the Institute's findings. For example, survey results released by the Federal Reserve Board in May 1993 indicate that bank participation in the mutual fund industry is increasing and that many banks plan to expand their offerings of proprietary funds. The Board's research also confirmed that most bank retail sales of proprietary funds are of money market funds rather than equity and fixed-income funds.[19] Similarly, a study by Cerulli Associates found that taxable and tax-free money market funds continue to represent more than two thirds of bank fund assets, although the percentage of equity and fixed-income funds increased from 1992 to 1993.

---

19 *Senior Financial Officer Survey on Retail Mutual Funds*, Board of Governors of the Federal Reserve System (May 12, 1993).

C. Factors Contributing to Increased Bank Mutual Fund Activities

A number of factors contribute to the increased participation of banking organizations in the mutual fund industry. Banks and their affiliates view mutual funds as a natural extension of fiduciary and investment management services which bank trust departments traditionally have offered their customers.[20] In addition, many banks have entered the mutual fund business in order to offer their existing customers alternative investment vehicles. Banking organizations have come to view the income generated from offering fee-based investment products, such as mutual funds, as an important component of their future profitability.

Banks and their affiliates can participate in the mutual fund industry in a number of different ways. First, they can make available to customers mutual funds sponsored and managed by third-party mutual fund organizations (*i.e.*, "nonproprietary" funds). Second, banks can offer their own proprietary funds, in which the bank or an affiliate serves as the fund's investment adviser. As noted previously, many bank proprietary funds are established through the conversion of the bank's existing tax-exempt trust assets.

Under current law, sales of both proprietary and nonproprietary funds to bank customers may occur through the bank itself or through a separate broker-dealer affiliated with the bank. An affiliated broker-dealer may either be a subsidiary of the bank or a separate entity within the same bank holding company. Alternatively, banks may enter into contractual arrangements (generally referred to as "networking" or "kiosk" arrangements) with independent broker-dealers, under which the bank leases space to a broker-dealer that sells mutual funds and other securities on bank premises. In addition to receiving fee income from selling and advising mutual funds, banks and their affiliates may obtain additional fee-based income from providing related services to mutual funds (such as administrative, custodial or transfer agent services).

D. Regulatory Issues Raised By Bank Mutual Fund Activities

The growing participation of banks in the mutual fund industry raises a number of regulatory issues.

---

[20] For example, bank trust departments have managed employee benefits trusts, institutional and corporate agency accounts and personal trust and agency accounts for many years. Banks also administer common trust funds which consist of the commingled assets of individual trust customers.

1. Investor Protection Issues

The first set of issues relates to the need to ensure that the interests of investors are protected when they purchase shares of mutual funds through banks and their affiliates. These issues fall into several categories: (1) issues which arise when banks or their affiliates *sell* mutual funds; (2) issues which arise when banks or their affiliates *manage or advise* mutual funds; and (3) issues relating to the *oversight* of bank mutual fund activities and the *enforcement* of relevant securities and banking laws.

a) Mutual Fund Sales

The principal sales-related issues raised by bank mutual fund activities include the risk of investor confusion when customers purchase mutual funds through banks or on bank premises, the regulation of the sales practices of bank employees, and the potential confusion created when banking regulators adopt disclosure requirements that differ from or duplicate standards of the SEC and the NASD.

Potential Investor Confusion: When banks or their affiliates sell mutual funds and other uninsured investment products, legitimate concerns exist that bank customers may erroneously conclude that the "safety net" provided by federal deposit insurance extends to such products. Federal banking regulators have emphasized the need for banks to make appropriate disclosures to customers regarding the uninsured nature of mutual funds and other investment products. Recent surveys suggest, however, that confusion among bank customers exists in this area. Some of this confusion is undoubtedly due to similarities in name between money market mutual funds and bank products of more recent origin such as "Money Market Deposit Accounts," which are federally insured.

While the survey results may reflect the manner in which specific questions were posed to survey respondents, the Institute believes that it is important to address the perception that confusion exists among members of the public when they purchase mutual funds through banks or any other distribution channel. Thus, the Institute is undertaking a major public education program in 1994, involving registered broker-dealers as well as banks, to ensure that customers understand the nature of the mutual fund products they purchase, including the fact that mutual funds are not insured by the federal government.[21]

---

[21] The Institute's initiative will include, among other things, a two-part video news release for distribution to 750 commercial television stations, a feature news release on mutual fund regulation for distribution to major news organizations, a news feature for distribution to 10,000 small weekly suburban and rural newspapers and a brochure describing fund risk and explaining the difference between insured and uninsured financial products. In recent

(footnote continued on following page)

In addition, with respect to sales of mutual funds by banks or their affiliates, the Institute began to work with its members in early 1993 to develop detailed guidelines on bank retail sales of mutual funds. The Institute's proposed guidelines, released in July 1993, specifically addressed

- the need for appropriate customer disclosures regarding the uninsured nature of mutual funds;
- the location of sales activities on bank premises;
- restrictions on the role of bank tellers in sales activities;
- the training and supervision of sales representatives; and
- compensation arrangements for bank employees involved in sales efforts.

Each of the federal banking agencies issued guidelines last year concerning the retail sale of bank mutual funds and other uninsured products.[22] The Institute submitted its guidelines to the various banking agencies to assist the agencies in the development of their own guidelines and to encourage the agencies to adopt uniform standards that contain appropriate safeguards for investors, without unduly interfering with legitimate activities.[23] The Institute views such guidelines (including the recent "Interagency Statement on Retail Sales of Nondeposit Investment Products") as an important *interim* step to protect the interests of mutual fund investors. As discussed below, however, the Institute believes that ultimate responsibility for regulating *all* sales of mutual funds, including sales by banks and their affiliates, should be vested in the SEC and self-regulatory organizations subject to SEC oversight (such as the NASD).

---

years, the Institute has conducted similar public education programs to inform customers of the risks associated with bond and income funds.

22 *See* Federal Deposit Insurance Corporation, "Supervisory Statement on State Nonmember Bank Sales of Mutual funds and Annuities," FIL-71-93 (October 8, 1993); Office of Thrift Supervision, "Guidance on the Sale of Uninsured Products," TB 23-1 (September 7, 1993); Office of the Comptroller of the Currency, "Retail Nondeposit Investment Sales," BC-274 (July 19, 1993); Board of Governors of the Federal Reserve System, "Separation of Mutual Fund Sales Activities From Insured Deposit-Taking Activities," SR 93-95 (June 17, 1993).

23 On February 15, 1994, the federal banking agencies issued an "Interagency Statement on Retail Sales of Nondeposit Investment Products" (the "Interagency Statement") which supersedes prior statements issued by the various agencies and is intended to "provide uniform guidance to depository institutions engaging in [sales] activities."

Regulation of Sales Practices: Many banks sell mutual funds through separate broker-dealer affiliates that are regulated as broker-dealers under the Exchange Act and the NASD's Rules of Fair Practice. Similarly, independent broker-dealers with which banks enter into "kiosk" or "networking" arrangements are also subject to SEC and NASD requirements. Among other things, employees of registered broker-dealers must pass an appropriate examination (such as the NASD's Series 6 or Series 7 examination) designed to ensure that they (1) understand the products they are selling; (2) determine what types of investments are suitable for customers with different investment objectives; and (3) provide customers with necessary and appropriate disclosures. Employees of registered broker-dealers must also comply with the NASD's Rules of Fair Practice, which establish additional standards with respect to retail mutual fund sales.[24]

Banks which sell mutual funds *directly*, however, are exempt from the definition of a "broker" under the Exchange Act and are not subject to SEC or NASD oversight. Thus, their employees are not required to take the NASD's Series 6 or Series 7 examination or comply with the NASD's Rules of Fair Practice. Although federal banking regulators have recently urged banks to ensure that bank employees participating in sales efforts are "adequately trained" and have received training "the substantive equivalent of that" required for registered representatives of registered representatives,[25] they have not defined what constitutes "adequate training" or the "substantive equivalent" of current SEC/NASD requirements. Thus, bank employees involved in mutual fund sales activities remain subject to less comprehensive and well-defined training and qualification standards than employees of registered broker-dealers (including bank-affiliated broker-dealers).

Disparate Disclosure Requirements: Guidelines issued by the federal banking agencies generally apply to *all* bank-related mutual fund sales, including sales by affiliated or third-party broker-dealers that are already subject to SEC and NASD disclosure standards. Because the guidelines issued by the federal banking agencies, however, are inconsistent in certain respects with SEC and NASD requirements, investors may receive duplicative and inconsistent disclosures.

One example of inconsistent disclosure requirements as between the federal banking agencies and the SEC involves money market funds, which account for a majority of bank mutual fund sales. The

---

24 *See, e.g.,* Art. III. § 26 of the NASD's Rules of Fair Practice.

25 *See* "Interagency Guidelines," *supra* note 24, at 11.

"Interagency Statement" issued by federal banking regulators states that when uninsured investment products (including money market funds) are marketed to retail customers, there must be conspicuous disclosures that the products are not FDIC-insured or guaranteed by the bank and that they are "subject to investment risks, including possible loss of the principal amount invested." The SEC, however, has previously required that all advertisements containing performance information concerning money market funds and prospectuses for such funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[26]

In addition, the SEC requires prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank (including a money market fund) that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank * * *."[27] The SEC-mandated disclosures accomplish the same objectives as the "Interagency Guidelines," but are tailored more precisely to the characteristics of money market funds.

b) <u>Bank Advisory Activities</u>

The Investment Company Act addresses the potential conflicts that may arise when a portfolio manager -- be it an investment adviser, broker-dealer, insurance company or a bank -- has investment discretion over a large pool of securities and other liquid assets and, in particular, the risk that an investment adviser will enter into transactions which benefit the adviser or a related party to the detriment of the fund's shareholders. Thus, Sections 17(a) and (b) of the Act prohibit "affiliated persons" of a mutual fund from engaging in transactions with the fund, except as expressly permitted by the SEC as consistent with the interests of investors. As a further discipline upon the activities of fund managers, Section 15 of the Act requires, among other things, that an investment adviser's contract with a mutual fund must be in writing, must precisely describe all compensation to be paid thereunder, and may be

---

26 Securities Act Rule 482(a)(7); Item 1, Form N-1A. This disclosure was mandated by the SEC in 1991 and is now standard throughout the industry. The SEC has also proposed to amend Rule 134 under the Securities Act to require inclusion of this disclosure is so-called "tombstone advertisements" that generally describe money market funds. *See* SEC Release No. IC-19959 (Dec. 17, 1993).

27 *See* Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993). Furthermore, the NASD requires that advertisements for mutual funds sold through banks disclose that fund shares "are not deposits or obligations of, or guaranteed by, the bank * * *." *See* NASD Notice to Members 93-87 (December 1993).

terminated "at any time, without the payment of any penalty" by the fund's board of directors or a majority of the fund's voting shareholders.

However, when the Act and its companion legislation, the Investment Advisers Act of 1940, were adopted, however, Congress understood that the Glass-Steagall Act operated to prohibit banks and their affiliates from serving as investment advisers to mutual funds. As a result, the current regulatory structure, which did not envision involvement by banks in the mutual fund industry, contains significant gaps. For example, banks that advise mutual funds are exempt from registration under the Investment Advisers Act.[28] As a result, the SEC can inspect the records of a bank-advised fund, but may be unable to review other bank records that may be relevant to an examination of the fund's portfolio transactions.

These regulatory gaps are not addressed by current banking laws, which also fail to address the specific conflicts that may arise when banks serve as investment advisers to mutual funds. For example, Sections 23A and 23B of the Federal Reserve Act apply to certain transactions between member banks and their affiliates, but are intended only to protect the *bank*, not fund shareholders. As a result, a credit arrangement between a bank and an affiliated fund on terms that are at least as favorable to the bank as the bank could obtain in an arm's-length transaction with a third party would raise no questions under Sections 23A or 23B, yet could be contrary to the interests of the fund's shareholders. Other regulatory gaps exist which are addressed by neither the Investment Company Act nor by other federal banking and securities laws.

c) <u>Oversight and Enforcement</u>

While many aspects of bank mutual fund activities are subject to SEC oversight, regulatory gaps exist because banks were viewed as barred from the mutual fund industry in the 1930s and 1940s and, therefore, exempted from important provisions of the federal securities laws. In response to the recent growth of bank participation in the mutual fund industry, federal banking agencies have attempted to fill these gaps. Federal banking regulators have different objectives than the SEC, however, and substantially less experience with the regulation of retail sales of mutual funds. As a result, banks that participate directly in mutual fund sales and advisory activities are subject to less stringent standards of oversight and enforcement than other participants in the industry, including bank-affiliated broker-

---

[28] *See* Investment Advisers Act, § 202(a)(11) (exempting banks and bank holding companies from the definition of "investment adviser" in the Investment Advisers Act). Affiliates and subsidiaries of banks which advise mutual funds are not covered by the exemption.

dealers. Moreover, because the banking agency guidelines also purport to apply to registered broker-dealers involved in bank mutual fund sales, such broker-dealers are subjected to inconsistent and duplicative regulatory schemes.

Congress specifically created the SEC in 1934 to protect investors in securities. In comparison, banking laws are designed to protect the safety and soundness of the nation's banking system. As former SEC Chairman William Cary aptly stated:

> The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection.[29]

Although banking agencies have experience with the regulation of bank products such as common trust funds and collective investment funds, mutual funds raise quite different investor protection concerns. In particular, mutual funds are heavily advertised and marketed largely to middle-income customers with varying degrees of experience with mutual funds and other uninsured investment products.

The different regulatory philosophies of the SEC and the federal banking regulators are illustrated by a comparison of the detailed regulation of mutual funds under the Investment Company Act and the rules thereunder with the OCC's more lenient regulation of collective investment funds under 12 C.F.R. Part 9. Among other things:

- The restrictions against self-dealing set forth in 12 C.F.R. § 9.18 are less extensive than the prohibitions in Section 17 of the Investment Company Act and the rules thereunder. For example, while a national bank managing a collective investment fund may not purchase or sell securities or other property from or to the fund, affiliates of the bank are not subject to this restriction. Affiliates of an investment adviser to a mutual fund would be barred from engaging in such transactions, unless expressly authorized by the SEC.

---

29 *Hearings on SEC Legislation, 1963*, before a Subcommittee of the Senate Committee on Banking and Currency, 88th Cong., 1st Sess. 20 (1963). *See also* FDIC Annual Report (1987) at 3 (noting that the purpose of the FDIC, as established by the Banking Act of 1933, was to "restore confidence in the banking system, protect depositors in the nation's banks and promote safe and sound banking practices").

- The OCC's rules on collective investment funds do not require national banks to adopt policies or procedures with respect to personal trading in securities by trust department employees. In comparison, Rule 17j-1 under the Investment Company Act requires *each* "access person" of a mutual fund (defined to include all employees of the fund with a significant ability to affect the fund's investment decisions) to notify the fund of *all* transactions in securities in which such person has any direct or indirect beneficial ownership.

- The OCC generally permits the unrestricted advertising of collective investment funds, although claims regarding future performance or comparisons to funds other than those offered by the bank are prohibited. In comparison, the Investment Company Act and the rules thereunder strictly regulate mutual fund advertising and prescribe, among other things, standardized performance information (including total return data for one, five and ten-year periods).

- National banks are not required to file copies of collective investment fund sales literature with the OCC. In comparison, investment companies must file copies of the full text of advertising and sales literature with the SEC and/or a self-regulatory organization subject to SEC oversight not later than 10 days after it is first transmitted or distributed to prospective investors.

- A bank administering a collective investment fund is only required to determine the value of the assets in the fund at least once every three months, whereas the Investment Company Act imposes a daily "mark-to-market" requirement.

The traditional approach of federal banking agencies to the regulation of bank securities activities has carried over to the recent initiatives involving bank mutual fund sales activities. Thus, rather than promulgate strict rules of general applicability, subject to exemptions in appropriate cases, federal banking agencies have issued "guidelines" to depository institutions on mutual fund sales activities, which permit each institution to exercise discretion with respect to its sales and training programs.[30]

---

[30] In a recent speech, the Comptroller of the Currency asserted that "[a]n advantage of guidance over regulation is that guidance sets a goal and allows bankers to use their discretion to find a way to achieve it." *See*

(footnote continued on following page)

Banking and securities regulators have also taken different approaches to the enforcement of banking and securities laws. Under the Investment Company Act, the SEC is authorized to bring an administrative cease-and-desist proceeding and to prohibit a person found to have willfully violated the Act (or other provisions of the federal securities laws) from serving as an employee, officer, director, member of an advisory board, investment advisor or principal underwriter of a mutual fund.[31] The SEC may also seek the entry of an injunction in federal court, as well as the imposition of substantial monetary penalties in connection with both cease-and-desist and injunctive proceedings.[32] Pursuant to its authority under the Act and other provisions of the federal securities laws, the Commission has brought numerous, highly publicized enforcement actions against broker-dealers and other securities industry professionals.[33]

In comparison, banking regulators are less likely to bring public enforcement actions against banks and bank employees suspected of potential violations, in light of their overriding concern with the safety and soundness of the banking system.[34] As former SEC Chairman John S.R. Shad once noted:

> A major thrust of the securities laws is full disclosure. By contrast, bank regulators are more concerned about the need for public confidence in banks, and therefore tend more toward confidentiality. The result is that the banking regulators' approach to their responsibilities under the securities laws is different from the SEC's.[35]

Remarks by Eugene A. Ludwig, Comptroller of the Currency, Before the Annual Convention of the American Bankers Association (Nov. 7, 1993).

31 *See* Investment Company Act, § 9.

32 *See* Investment Company Act, §§ 9 and 42.

33 During the fiscal year ended September 30, 1992, the SEC instituted 115 administrative proceedings against broker-dealers and 51 separate actions against investment advisers, investment companies and/or transfer agents. *See* Securities and Exchange Commission, 1992 ANNUAL REPORT, at 108-09.

34 Under 12 U.S.C. § 1818(u), the federal banking agencies are required to "publish and make available to the public" final orders issued in connection with enforcement proceedings. Unlike the detailed releases published by the SEC upon the commencement or settlement of an SEC enforcement action, the releases issued by the banking agencies usually do not describe the nature of the violation and the enforcement action taken.

35 *See Securities Activities of Depository Institutions, Hearings on S. 1720 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 35 (1982).

The recent banking agency guidelines underscore that bank regulators would probably seek far less significant penalties against banks for violations of investor protection standards than the SEC has typically sought against participants in the securities industry in similar situations. In particular, the "Interagency Statement" states only that "[t]he failure of a depository institution to establish and observe appropriate policies and procedures * * * will be subject to *criticism and appropriate corrective action*."

Thus, it is highly questionable whether a federal banking agency would ever treat a major bank as severely in an enforcement action as the SEC has treated major brokerage firms, such as Drexel Burnham Lambert and, more recently, Prudential Securities. The knowledge by participants in the securities industry that the SEC is prepared to bring such proceedings, however, undoubtedly has an *in terrorem* effect which benefits investors in mutual funds and other securities. Unless similar enforcement standards apply with respect to bank mutual fund sales activities, investors in bank-sold or bank-advised funds may not enjoy comparable protections.

2. Safety and Soundness Issues

Another issue raised by the growth of bank mutual fund activities is the potential impact of such activities on the safety and soundness of financial institutions which expand their commitment to the mutual fund business. If investor protection issues are properly addressed through appropriate amendments to the federal securities laws, the Institute does not believe that bank participation in the mutual fund industry should pose a threat to the safety and soundness of depository institutions.

If any risk *does* arise from bank participation in the mutual fund industry, however, it will result from the failure to treat banks similarly to other participants in the business subject to full SEC oversight and regulation. Thus, if bank-sold or bank-advised mutual funds are regulated essentially as "bank products," subject only to partial regulation by the SEC, there is a heightened risk that banks may incur liability in connection with their mutual fund-related activities, which in turn might pose a potential threat to their safety and soundness.

Support for this conclusion is found in the experience of bank-sponsored real estate investment trusts ("REITs") during the 1970s. In the mid-1970s, many large REITs were sponsored or managed by commercial banks or their affiliates. In general, these REITs were exempt from regulation as investment companies, pursuant to Section 3(c)(5)(c) of the Investment Company Act. In the late 1970s, REITs

began to incur substantial losses due to a downturn in the real estate market; abusive transactions between the REITs and their advisers and affiliates contributed to these losses.[36]

Although the REITs were legally separate entities from the banks that managed them, large commercial banks extended additional credit to affiliated REITs out of concern that a REIT failure would have a "spillover effect" on the banks.[37] Had the REITs been subject to full regulation under the Investment Company Act, however, many of these potential losses could have been avoided, since the abusive transactions between the REITs and affiliated banks would have been prohibited and the management fees charged by the banks serving as the REIT advisers would have subject to review by an independent board of directors. Had these safeguards existed, the separateness of the REITs from their affiliated banks more likely would have been respected and the banks would *not* have felt obliged to place their own capital at risk.

In a recent speech, Comptroller Ludwig commented that the sale of mutual funds by banks "raises few if any safety and soundness concerns."[38] The experience with REITs in the 1970s, however, suggests *not* that mutual fund sales by banks raise "few if any" safety and soundness concerns, but rather that the potential risks can be *minimized* by subjecting such activities to full regulation under the Investment Company Act and other provisions of the federal securities laws. Banks will most likely succeed in the mutual fund industry if they are held to SEC-enforced investor protection standards and banking regulators resist the urge to regulate bank-sold and bank-advised mutual funds as traditional banking products. Of course, if bank mutual fund sales activities raise "few if any safety and soundness concerns," as suggested by Comptroller Ludwig, *no* rationale would exist for bank regulators to regulate such activities instead of the SEC.

---

36 During hearings before Congress, it was noted that many bank-affiliated REITs paid excessive advisory fees, incurred high levels of debt to support new bank loans, and borrowed funds on terms that were advantageous to the bank, but not the REIT. *See Real Estate Investment Trusts, Hearings on S. 2721 Before the Senate Committee on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. (1974) at 107-25.

37 *See* Garten, "Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age," 57 FORDHAM L. REV. 501, 555 n.308 (1989).

38 *See* Remarks by Eugene A. Ludwig, Comptroller of the Currency, Before the Consumer Federation of America (Dec. 3, 1993).

Insofar as federal banking agencies need to confirm that bank mutual fund sales activities do not adversely impact the safety and soundness of financial institutions, however, duplicative examinations by the SEC and the federal banking agencies should be avoided. In particular, the SEC should be responsible for the oversight and examination of bank securities activities, which should be conducted by a separate broker-dealer affiliate or subsidiary of a bank. The SEC could discuss its examination procedures with banking agencies and convey the results to banking regulators either informally or through a certification procedure. This process would avoid the imposition of duplicative inspections, yet promote the dual goals of investor protection and safety and soundness.

3. Impediments to Bank Mutual Fund Activities

a) Impediments Resulting from the Glass-Steagall Act

While the current regulatory structure contains certain significant gaps, it also presents impediments to banks wishing to engage in the mutual fund business. For example, under the Glass-Steagall Act, banks are prohibited from sponsoring mutual funds or underwriting and distributing the securities of mutual funds. In addition, the Glass-Steagall Act also prohibits officers, directors or employees of member banks from serving as an officer, director or employee of a mutual fund. As the federal banking agencies and the federal court have allowed banks to engage in other mutual fund-related activities, the remaining restrictions imposed by the Glass-Steagall Act are increasingly perceived as "statutory vestiges" that serve no useful purpose.

b) Impediments Resulting from Banking Agency Guidelines

Even though the federal banking agencies recently issued an "Interagency Statement" regarding bank mutual fund sales activities, many aspects of their regulation of sales activities will continue to be determined on an agency-specific basis. For example, the OCC issued its own "Nondeposit Investment Sales Examination Procedures" just nine days after the "Interagency Statement" was released.[39] The adoption of different, and conflicting, standards by the various federal banking agencies governing mutual fund sales at banks imposes a number of different burdens on banking organizations.

In particular, different banks within a holding company structure may have different sales-related obligations, depending upon whether the banks are national banks, state member banks or state nonmember banks. As a result, senior management of the bank holding company would have to

---

39 *See* OCC Bulletin 94-13, "Nondeposit Investment Sales Examination Procedures" ("OCC Sales Procedures") (Feb. 24, 1994).

familiarize itself with the standards adopted by *each* banking agency, as would fund companies marketing mutual funds through bank distribution channels. These are *precisely* the types of concerns which led the Clinton Administration to propose the consolidation of the four principal bank regulatory agencies.[40]

Other impediments exist as well. For example, registered broker-dealers participating in bank mutual fund sales activities are already subject to SEC and NASD regulations. The recent banking agency guidelines, however, also apply to sales activities of registered broker-dealers on bank premises, and require banks to take steps to ensure that such broker-dealers comply with the guidelines. These requirements impose a compliance burden on banks which they may not be equipped to assume. In addition, they increase the likelihood that a bank will be held liable for the sales activities of broker-dealers, which raises safety and soundness issues.[41]

Finally, third-party broker-dealers may prove reluctant to enter into networking arrangements with banks if, as a result, they must comply with regulations issued by the federal banking agencies, in addition to extensive SEC and NASD requirements to which they are already subject. In particular, such broker-dealers may prove unwilling to permit banks having less experience in the mutual fund industry

---

40 *See, e.g.*, "Clinton Seeking to Consolidate Bank Agencies," THE NEW YORK TIMES (Nov. 24, 1993), at 1 (statement by Treasury Secretary Lloyd Bentsen that it "makes no sense to have four separate agencies, overlapping, often in conflict, in charge of our financial institutions"); "Treasury Unveils Plan for Regulatory Consolidation It Hopes to Move Next Year," BNA'S BANKING REPORT (Nov. 29, 1993), at 825 (statements by Comptroller of the Currency Eugene Ludwig that regulatory consolidation is "an idea whose time has come" and by OTS Acting Director Jonathan Fiechter that federal insured depository institutions should be subject to "a more consistent set of operating rules").

41 The OCC has suggested that banks can address this litigation risk by requiring third-party vendors to indemnify the bank "for any liability that resulted from third party investment product sales program actions." *See* OCC Sales Procedures at 13. Since the OCC also suggests, however, that "[b]ank management must plan to monitor compliance by other entities on an ongoing basis," such indemnification provisions may not prove effective. *See id.* at 3. In addition, third-party vendors may prove unwilling to enter into such arrangements if bank management can dictate their sales procedures.

Indeed, the position taken by the OCC in its recent guidelines appears to be inconsistent with the agency's earlier statements regarding proposed networking arrangements between banks and third-party broker-dealers. Until recently, the OCC had emphasized when reviewing such arrangements that a bank should *not* assume responsibility for the broker-dealer's operations, precisely in order to minimize the bank's potential liability. The OCC had pointed out that such brokers were subject to SEC and NASD oversight and that its operations on bank premises were considered a branch office of the broker-dealer for regulatory purposes, subject to full inspection by the SEC during normal business hours. *See, e.g.*, OCC Staff Interpretive Letters Nos. 533 (Oct. 5, 1990), 441 (Feb. 17, 1988) and 406-408 (Aug. 5, 1987).

to establish their advertising and sales procedures. The impact would be borne primarily by smaller banks, which often enter into networking arrangements with third-party broker-dealers as an alternative to selling mutual funds directly or establishing a separate affiliate for this purpose.

E. Legislative Reforms

1. Summary of Needed Reforms

The Institute supports comprehensive reform legislation to fill current regulatory gaps and facilitate bank participation in the mutual fund business. Such legislation would grant banks full mutual fund powers (*e.g.*, the authority to underwrite mutual funds), as well as eliminate Glass-Steagall restrictions on the ability of officers, directors or employees of member banks to serve on the board of directors of a mutual fund.

In addition, the Institute favors legislation to eliminate the current exemptions of banks from the definitions of "broker" and "investment adviser" under the federal securities laws. The Institute also believes that Congress should require that banking organizations conduct *all* retail sales of mutual funds through separate broker-dealer affiliates subject to oversight by the SEC and self-regulatory bodies such as the NASD. As discussed above, many banks already conduct all of their retail mutual fund sales through such registered broker-dealers. Furthermore, Congress should amend the Investment Company Act to address the potential conflicts that arise when a bank or its affiliate serves as investment adviser or provides related services to a mutual fund. These provisions were considered unnecessary when the Act was adopted, because Congress understood that the Glass-Steagall Act barred banks from the mutual fund industry. As this rationale no longer applies, such investor protection provisions are now essential.

Proposals to amend the federal securities laws to require new bank securities activities to be conducted through separate securities affiliates subject to SEC regulation, as well as to amend the Investment Company Act to address potential conflicts created when banks and their affiliates advise mutual funds, were included in both S. 543, "The Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991," and H.R. 6, "The Financial Institutions Safety and Consumer Choice Act of 1991." The Institute believes that the basic approach reflected in these bills is sound and merits further consideration.

2. The SEC Should Have Primary Responsibility for Bank Mutual Fund Activities

The Institute's recommendations are based on the conclusion that investors in mutual funds are best protected if *all* participants in the mutual fund industry are fully subject to the same regulations, enforced in the same manner by the single federal agency which Congress specifically created to protect investors in securities -- the SEC. No other federal agency has this exclusive mandate and no other

federal agency has comparable experience in protecting investors and administering the requirements of the federal securities laws.

a) The SEC Has the Requisite Experience

The Investment Company Act specifically contemplates SEC regulation of the mutual fund industry and provides the SEC with broad regulatory authority to meet new conditions. In administering the Act over the past 50 years, the SEC has demonstrated its ability to address, in a flexible manner, the issues raised by new entrants in the mutual fund industry.

For example, when the Investment Company Act was enacted in 1940, most mutual funds were managed by traditional fund companies and money management firms. Later years, however, witnessed increased participation in the mutual fund industry by broker-dealers and insurance organizations. Because the SEC was prepared to administer the Act's requirements flexibly, without losing sight of the Act's key purposes and objectives, the Commission was able to accommodate these new entrants while at the same time protecting mutual fund shareholders.

Regulation of Broker-Dealers: Prior to the 1950s, brokerage firms sold shares of mutual funds, but did not sponsor or advise mutual funds in large numbers. When this trend began to change in the 1950s, Section 10(f) of the Act initially served as a potential impediment to the increased participation of broker-dealer firms in the industry. Section 10(f) generally prohibits a mutual fund from purchasing, during the existence of an underwriting syndicate, any security underwritten by the fund's investment adviser or by any "affiliated person" of the investment adviser. However, the section also authorizes the SEC to exempt a transaction from these restrictions, by rule or by order, if an exemption would be consistent with the protection of investors.

After broker-dealers that served as investment advisers pointed out that Section 10(f) would severely impede their ability to purchase shares in initial public offerings for funds they advised (given the large number of broker-dealer firms that participate in underwriting syndicates), the SEC responded by issuing exemptive orders in specific cases where the Commission was satisfied that the proposed acquisition of securities was fair to investors. Moreover, after the SEC gained additional experience with such situations, the Commission adopted Rule 10f-3 under the Act, a broader rule permitting acquisitions

of securities during the existence of an underwriting syndicate, if the purchases meet criteria designed to ensure their fairness to mutual fund shareholders.[42]

Regulation of Insurance Companies: The SEC has also demonstrated its ability to adjust the requirements of the Investment Company Act to accommodate insurance companies. During the 1950s, insurance companies entered the investment field by offering variable annuities, pursuant to which premium payments were allocated to investment portfolios maintained by an insurance company in a segregated or "separate account." Because purchasers of such products assume investment risks similar to investors in mutual funds, the SEC took the position that a separate account was an "investment company" for purposes of the Investment Company Act and that the variable annuities themselves were "securities" required to register under the Securities Act.[43] In addition, the sale of variable annuities by an insurance company required the company to register as a broker-dealer under Section 15(a) of the Exchange Act.

Under the Investment Company Act, *any* broker-dealer is considered an "interested person" of *any* mutual fund, as are its employees.[44] Since the Act restricts the percentage of a fund's board of directors who may be "interested persons," the requirement that insurance companies register as broker-dealers limited the ability of an insurance company's officers and employees to serve as mutual fund directors. However, the SEC recognized the substantial burden imposed by this restriction, and agreed to grant exemptions when it was clear that the proposed mutual fund directors were *not* involved in the day-to-day operations of the insurance companies' securities activities and the companies did not offer brokerage services to the general public.[45] The SEC has subsequently codified these exemptions as rules under the Act.

In recent years, banks and their affiliates have entered the mutual fund industry in large numbers. As these examples demonstrate, the SEC has been able to tailor the requirements of the Investment Company Act to address situations which raise novel issues or merit special accommodation under the

---

42 *See* Investment Company Act Rel. No. 2797 (Dec. 2, 1958).

43 The Supreme Court upheld the SEC's position in *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959).

44 *See* Investment Company Act, § 2(a)(19).

45 *See generally* T. Frankel, THE REGULATION OF MONEY MANAGERS D§ 29, at 561-62 (1978).

Act. Thus, no basis exists to conclude that bank mutual fund sales activities raise unique issues which justify their regulation by federal banking authorities, rather than by the SEC.

b) **The SEC Is Prepared To Exercise Full Oversight Over Bank Mutual Fund Activities**

Although all mutual funds advised and/or sold by banks are registered under the Investment Company Act and the Securities Act, the exemption of banks (but not bank-affiliated broker-dealers) from other provisions of the federal securities laws restricts the ability of the SEC to fully regulate bank mutual fund activities. While the Commission has not ignored such activities, the current limitations on the SEC's authority significantly hamper the Commission's oversight role. It should be noted, however, that the SEC has repeatedly requested additional authority over bank mutual fund activities from Congress. Indeed, every Chairman of the SEC since 1980 has supported amendments to the federal securities laws to subject bank mutual fund activities to full SEC regulation.

For example, former SEC Chairman John S.R. Shad testified in 1984 before the Senate Banking Committee that banks should be required to conduct securities activities through separate holding company affiliates subject to SEC oversight. Chairman Shad also noted that banks which advised mutual funds should be subject to full regulation under both the Investment Company Act and the Investment Advisers Act, since "these statutes provide a comprehensive scheme of investor protections."[46] In 1987, former SEC Chairman David S. Ruder similarly testified in favor of full SEC regulation of bank securities activities and noted that "the Investment Company Act must be amended to include protections not deemed necessary when bank activities in this area were restricted."[47]

Former SEC Chairman Richard C. Breeden and Arthur Levitt, the Commission's current Chairman, have also expressed their strong support for expanded SEC authority over bank mutual fund activities. In November 1993, Chairman Levitt testified before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs that:

---

46 *Competitive Equity in the Financial Services Industry: Hearings on S. 2181 and S. 2134 Before the Senate Committee on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 1523-27 (1984) (testimony of John S.R. Shad, Chairman, Securities and Exchange Commission).

47 *Legislative Proposals to Restructure Our Financial System: Hearings on S. 1886, S. 1891 and S. 1905 Before the Senate Committee on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 271 (1987) (testimony of David S. Ruder, Chairman, Securities and Exchange Commission).

> Even though the Commission can regulate bank sponsored or advised funds registered under the Investment Company Act, its ability to regulate the persons who advise and sell interests in those funds is circumscribed * * *. The Commission historically has maintained that [bank exclusions from the definition of a "broker" under the Exchange Act and definition of an "investment adviser" under the Investment Advisers Act of 1940] should be removed. I, too, advocate that organizations providing similar products and services should be subject to the same regulation * * *.[48]

The Commission has exercised its authority over the mutual fund-related activities of banks when permitted to do so under current law. Examples of the SEC's ability to address bank mutual fund activities raising significant investor protection issues include:

- The SEC's May, 1993 letter to all registered investment companies, which stated that all funds advised, sold, or marketed by or through federally insured institutions must prominently disclose, on the cover of their prospectuses, that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by the bank, and that the shares are not federally insured by the FDIC, the Federal Reserve Board or any other agency;[49]

- The SEC's advice to banks that so-called "IRA funds" (bank-sponsored common trust funds established to pool individual retirement accounts) are not exempt from registration under the Investment Company Act and that interests in such funds are "securities" required to register under the Securities Act;[50]

---

48 *Hearings Concerning the Investment Company Industry Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs,* 103d Cong., 1st Sess. (1993) (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission).

49 *See* Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993). The SEC has required similar disclosures in money market fund prospectuses since 1991. *See* ICA Rel. No. 18005 (Feb. 20, 1991).

50 *See, e.g., Cititrust* (pub. avail. Mar. 31, 1979); *United Missouri Bank of Kansas City, N.A.* (pub. avail. Dec. 31, 1981); *Hibernia Nat'l Bank of New Orleans* (pub. avail. Sept. 24, 1986).

- The SEC's advice to the OCC that common trust funds would lose their exemption from registration under the Investment Company Act and the Securities Act if the funds' performance record were widely advertised to potential customers;[51] and

- The SEC's application of Investment Company Act Rule 17f-2 (the "self-custody rule") to situations in which a bank serving as investment adviser to a mutual fund also provides custodial or depository services.[52]

Thus, if Congress were to address the remaining, anomalous situations where the SEC lacks full authority over back mutual fund sales activities (*i.e.*, where sales occur directly through banks or banks serve as the investment adviser), there is every indication that the SEC would exercise this additional authority to protect investors.

3. Comments on H.R. 3306

The Institute believes that H.R. 3306 seeks to address valid investor protection and safety and soundness issues raised by the increased participation of banks and their affiliates in the mutual fund industry. The Institute embraces the bill's overall objectives and commends the bill's sponsors for highlighting these important issues in H.R. 3306. Indeed, the Institute is concerned with many of the key issues that H.R. 3306 attempts to address, including:

- The adequacy of disclosures provided to investors who purchase mutual funds by or through banks and their affiliates;

---

51 *See* Statement of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the House Energy and Commerce Committee (Oct. 4, 1990); Letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to Robert L. Clarke, Comptroller of the Currency (July 9, 1990). In response to this letter, the OCC issued a banking circular advising banks that they were required to register common trust funds under the Investment Company Act and the Securities Act if the underlying trust accounts were established solely or primarily for the purpose of investment in the common trust fund or lacked a "bona fide fiduciary purpose." *See* OCC Banking Circular 247 (Sept. 12, 1990).

52 Rule 17f-2(f) provides that securities and similar investments of a mutual fund in the custody of such fund must be verified by actual examination by an independent public accountant retained by the fund at least three times during each fiscal year (including on at least two occasions without prior notice to the fund). In a series of no-action letters, the SEC has made clear that this rule applies to situations in which a bank serves as investment adviser to a fund and also acts as the fund's custodian or sub-custodian. *See The Mutual Fund Group* (pub. avail. Dec. 12, 1989); *Pegasus Income and Capital Fund, Inc.* (pub. avail. Dec. 1, 1977).

- The locations on bank premises at which mutual fund sales activities take place;

- Training and qualification requirements for bank employees involved in retail mutual fund sales activities;

- The role of tellers and other persons who accept deposits in sales activities; and

- Compensation programs for bank employees who participate in sales activities (including the payment of referral fees to employees who direct customers to designated sales representatives).

While the Institute applauds the investor protection goals of H.R. 3306, the Institute does not believe that Congress should perpetuate a second, duplicative regulatory system by conferring additional authority on federal banking regulators to establish investor protection standards for bank mutual fund sales activities. This responsibility properly belongs to the SEC, which was specifically established to protect investors and has extensive experience in this area. The Institute recognizes that H.R. 3306 contains a "savings clause" stating that "no provision of [proposed new Section 44 of the Federal Deposit Insurance Act] shall be construed as limiting *or otherwise affecting*" the authority of the SEC or any self-regulatory organization. In light of the many responsibilities which the SEC and the NASD already have with respect to bank mutual fund sales activities, however, interference by the federal banking agencies with the SEC's and NASD's responsibilities undoubtedly would occur.

Since other participants in the mutual fund industry are subject to full SEC oversight and regulation, Congress should not promote the creation of a "parallel universe" of mutual fund regulators and regulations for bank mutual fund sales. To do so would elevate corporate form over substance, by subjecting banks which engage directly in mutual fund sales activities to one set of standards, established and enforced by banking regulators, while *all* other participants in the industry (including bank-affiliated broker-dealers) are subject to SEC and NASD oversight and regulation. At a time when government agencies are being asked to "tighten their belts," Congress should not direct federal banking agencies to hire and train a *new* "mini-SEC" staff to issue *new* regulations and conduct *new* examinations, when the SEC already exists, has demonstrated its ability to perform these functions and has repeatedly requested that Congress close the remaining "regulatory gaps" in its authority.

As drafted, H.R. 3306 would further contribute to the creation of a duplicative and inconsistent regulatory scheme for banks and other entities which participate in bank mutual fund sales activities. For example:

- H.R. 3306 would require the federal banking agencies to jointly prescribe "rules of fair practice" for retail sales of nondeposit products "by, on behalf of, or in any office of, any insured depository institution * * * any affiliate of such institution." The banking agencies would be required to consider, *but not follow*, the NASD's Rules of Fair Practice when prescribing their own rules. As a result, banks would be subject to different standards than registered broker-dealers (including bank-affiliated broker-dealers), and a broker-dealer involved in sales of mutual funds on bank premises would be subject to *both* the NASD's Rules of Fair Practice and the practice rules adopted by the federal banking agencies.

- H.R. 3306 would require any advertisements, solicitations, and promotional and sales materials relating to the sale of nondeposit products to include mandatory written disclosures that such products are not insured by the FDIC and pose some investment risk and may involve the loss of principal. As noted, such disclosure requirements would differ from existing disclosure requirements for money market funds established by the SEC and the NASD which are designed to accomplish the same objectives.

- H.R. 3306 would permit bank employees to sell mutual funds and other nondeposit products if they met qualification and training standards determined jointly by the federal banking agencies. Unlike employees of *all* registered broker-dealers, however, such employees would not be required to meet the training and qualification requirements of the NASD (*i.e.*, they would not be required to pass a Series 6 or Series 7 examination).

- H.R. 3306 would direct federal banking agencies to adopt regulations establishing "minimum requirements" for an institution's compensation program for employees involved in sales activities. Such regulations would be intended to ensure that compensation programs do not provide an incentive for the sale of nondeposit products to a customer "in lieu of a more suitable investment option." Even if the banking agencies (which long followed different standards on permissible retail sales arrangements) developed workable standards in this area, those standards would conflict with provisions of the NASD's Rules of Fair Practice governing compensation arrangements.

Congress should not require the federal banking agencies to issue new disclosure, training and compensation standards with respect to bank sales of mutual funds, when detailed SEC and NASD standards on retail sales activities already exist. Banks could -- and should -- be made fully subject to

such standards through a limited number of amendments to the federal securities laws and should not be subject to a duplicative scheme of regulation under federal banking laws.

V. CONCLUSION

The increased participation of banks in the mutual fund business reflects the industry's past successes and the high level of public confidence in mutual funds. Bank entry into the mutual fund business has been a positive development for the banking industry, the mutual fund industry and the public. By and large, banks appear to be conducting their mutual fund activities responsibly and within the framework of existing law.

The future success of bank and nonbank participants in the mutual fund industry alike, however, depends on the public's sustained confidence in mutual funds as a means to obtain the benefits of professional money management and diversification of investments. The Institute is committed to addressing the issues raised by the expansion of mutual fund sales through banks and other depository institutions, including the paramount goal of investor protection. We thank you for this opportunity to present our views and look forward to working with this Subcommittee as these issues develop.

CFA

Consumer Federation of America

STATEMENT OF CHRIS LEWIS
DIRECTOR OF BANKING AND HOUSING POLICY
CONSUMER FEDERATION OF AMERICA

ON

BANK SALE OF UNINSURED PRODUCTS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND DEPOSIT INSURANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

HONORABLE STEPHEN L. NEAL
CHAIRMAN

MARCH 8, 1994

The Consumer Federation of America appreciates the opportunity to testify before the Subcommittee today on the subject of bank sale of mutual funds and related uninsured investment instruments.

Today, some 113 banks advise 943 mutual funds. Bank mutual funds have over $204 billion in assets, an increase of 29% since December 31, 1992.[1] And, banks are increasingly active in the retail sale of mutual fund shares to consumers. In fact, last year, the banking industry, with the shield of the Federal Deposit Insurance Corporation (FDIC) displayed prominently in every bank, peddled some $92 billion of mutual fund shares to an unwary public.

The increased securities activities of the banking industry raises a number of critical public policy concerns. Among them is the certain increase in consumer confusion about the degree of risk of investment products sold on the premises on insured depository institutions and that federal banking law is woefully inadequate in providing basic protections for consumers.

---

[1] Lipper Analytical Services, **Lipper Bank Related Fund Analysis**: (2d ed. 1993).

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Over the past two decades, creative interpretations of the Glass-Steagall Act by banking regulators have permitted vastly expanded bank involvement in the mutual fund and other securities business activities.

CFA believes that the current headlong rush by the banking industry into the retail mutual fund business must be placed in proper perspective.

First, there is no known clamor by consumers for further expansion by banks into the mutual fund business. CFA monitors consumer demands nationwide and the organization is not aware of a consumer push for more mutual fund outlets -- whether operated by banks or other entities. Similarly, we are unaware of consumers knocking on the doors of the Congress in demand for bank operated mutual funds.

Second, we are aware that the banking industry enjoyed record setting profits last year, as in the previous year, and there seems to be no emergency need to open new lines of business to protect the earnings of the industry.

Third, we are aware -- through both government and private surveys -- that there is widespread confusion among the public about the nature of risk associated with investment products, including mutual funds, sold by banks and bank subsidiaries.

Finally, the Congress, through bills introduced by Chairman Gonzalez and Congressman Schumer, Congressman R. Neal and Chairman Dingell of the Energy and Commerce Committee, are attempting to establish specific statutory guidelines to end the confusion among the banks and the regulators -- and most importantly among the public about the nature of risk of investment products sold on the lobby floors of banks and thrifts.

A TARNISHED FDIC SHIELD

We believe that the evidence clearly indicates that the banks' uninsured investment products sales practices are all too often designed to lead the unsuspecting customer into believing that good-ole Uncle Sam and the taxpayers are guaranteeing the investments. The funds -- like all investments in the stock market -- carry risk and none of that risk is insured or protected in any manner by the Federal government.

In short, Mr. Chairman, the protective shield of the Federal Deposit Insurance Corporation (FDIC) -- symbol of security for millions of American consumers -- is being tarnished by bankers hell-bent on becoming big-time players in Wall Street's mutual funds and annuities market.

The banking industry, as well as the Congress and the American public, should want that shield protected. Certainly, the full

faith and credit of the United States taxpayers -- symbolized by that FDIC logo -- should not be utilized by the banks as a means -- directly or indirectly -- of duping customers into believing that investments in the stock market are risk-free. There should be no question about what that shield protects and what it does not protect.

CONSUMER CONFUSION REIGNS

Little wonder, then, that unsuspecting customers -- lulled into a false sense of security by decades of fail-safe insurance for their deposits -- walk out of banks thinking their investments are risk-free.

In January, a survey released by the American Association of Retired Persons (AARP) and the North American Securities Administrators Association (NASAA)[2] revealed that 82% of American consumers are unaware that mutual funds sold through banks are not insured by the FDIC. Ironically, the AARP survey found that consumers who have actually purchased mutual funds at their bank are even less well informed about the risks associated with such investments than are other bank customers.

Last November, the Securities and Exchange Commission released survey data that found similar levels of confusion among bank customers concerning the uninsured status of mutual funds sold by banks.

The fact is that consumers are not well informed about the risk of investment products peddled by banks. We need not conduct further studies to determine that there is a serious problem in the lobbies of insured financial institutions.

DECEPTIVE MARKETING BY BANKS

Bank marketing efforts are clearly adding fuel to the firestorm of confusion. A recent report of the New York City Department of Consumer Affairs[3] revealed that only 40% of surveyed banks stated that mutual funds were not FDIC insured. The report also observed far more aggressive sales tactics by banks compared to that of mutual fund companies:

"Generally, the bank representatives gave a much harder

---

[2] American Association of Retired Persons and the North American Securities Administrators Association: **Bank Investment Products Survey**: January 13, 1994.

[3] New York City Department of Consumer Affairs: **Making Sense of Mutual Funds: Tricks of the Trade and Lessons for Investors**: August 1993.

> sell than the fund company representatives, perhaps because the bank agents earn commissions, while the fund-company agents generally do not. For example, agents from both Citibank and Chase were hesitant to give information over the phone or through the mail, but particularly eager to have the undercover Consumer Affairs investigator who phoned come into the office for a face-to-face sales presentation. Without understanding much about mutual funds, face-to-face sales presentations can be intimidating to new investors.
>
> Furthermore, bank customers who become first time mutual-fund buyers are generally more cautious and conservative than those more familiar with the territory. But few bank employees selling mutual funds pushed conservative investments....[A]ll of the five bank representatives pushed the higher-yielding, and more risky growth funds rather than the more conservative bond funds."[4]

A letter CFA recently received from a former chief Investment Officer of one of the nation's largest bank holding companies additionally attests to problems of deception in the sale of uninsured products by banks.

> "It is true that the majority of bank investors have no clue that their investments are not insured; most have no idea that their government bond funds are not guaranteed by the government....[A]ll of the incentives are tied directly to meeting expected sales quotas and undue sales pressure put on bank reps to sell these less than stellar funds.
>
> In making a comparison to the regulations followed by both banks and brokerage firms, there is no comparison....banks have almost no regulation at all. There are no principled managers at the banks offices, reps are left to oversee other reps, bankers with no licensing at all are sending solicitation letters to bank customers to buy mutual funds, bankers are paid bonuses for making referrals to the brokers as well as trips are paid as bonuses for making referrals to the brokers as well as trips are sponsored by the fund companies to solicit the business of the bank reps."

And, most recently, Consumers Union reports in the March 1994 edition of Consumer Reports that consumers can expect that "the odds of getting good advice at a bank that sells mutual funds are worse than 1 in 6".[5]

---

[4] **Ibid.**: pgs. 29-30.

[5] Consumer Reports: **Should You Buy Mutual Funds From Your Bank?**: Volume 59, No. 3, March 1994, p. 148.

BANK REGULATORS RESPONSE

The response by the bank regulatory agencies to the rising tide of securities activity by depository institutions has been a classic example of those agencies age-old approach -- "banks first and consumers last".

In essence, the regulators have suggested that consumer safeguards are just fine so long as the protections don't interfere with the banks' headlong rush for profits.

Last month the Washington Post, quoting data collected by the American Bankers Association, noted that the four agencies had produced four different answers about the seriousness of the confusion created by mutual funds bearing the identical or similar name of an insured bank.

Two weeks ago the agencies -- faced with mounting publicity and with the prospect of action by this Committee and the Banking Committee -- finally decided that they were all part of the same government and came up with an "Interagency Statement" on retail sales of non-deposit investment products.

What has emerged in this "policy" statement is a set of lowest common denominators with "should" -- not "shall" -- the dominant verb.

I quote the regulators:

> "Moreover, sales activities involving these investment products <u>should</u> be designed to minimize the possibility of customer confusion and <u>to safeguard the institution from liability</u>..."

In a number of critical areas the "Interagency Statement" does not correct egregious practices. Rather, it institutionalizes them.

For example, on page 8 of the statement, the regulators endorse the use of promotional brochures and advertising where both uninsured and insured products are advertised together.

The agencies only suggest that the material "clearly segregate" the information. What does this mean? Two space between the two distinctly different products or on separate pages of the same brochure?

This is reckless guidance. The two products -- insured and uninsured -- should not appear in the same advertisement or in the same promotional brochure. No segregation within the same document or the same advertisement on television on in newspapers will do the job -- it only ensures more confusion for the investing public.

And when it comes to the big problem of "name" -- the use of an insured bank's logo or name -- the agencies again take the easy

way out. A "similar" name should be used, the regulators say, in a sales program "designed to minimize the risk of customer confusion". In short, bankers can be creative in duping customers -- be a little subtle in sliding that FDIC logo in front of the mutual fund customer.

The separation has to be total -- no similarities -- or the regulation is a further fraud on the public.

On the critical matter of the separation of personnel, the agencies provide a road map for the banks to make full utilization of personnel across the lines of insured and uninsured products.

The interagency statement allows personnel which handle insured deposits to "recommend" investment products so long as they have "reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer."

Translation: you don't need separate personnel -- and if this confuses the public about government insurance, too bad.

And if this is not enough, the tellers are to be allowed "nominal fees" to encourage the referral of customers for non-deposit investment products.

So what happens to an elderly consumer when she walks in to the bank seeking a safe place for the $50,000 she has just earned in the sale of her house? Does the teller -- with the thoughts of a referral fee at hand -- urge her to forego government insurance and, instead, invest in some of those nice securities being sold at the desk across the lobby?

And if this happens, how do the examiners and the supervisors really detect the game? The answer, we believe, is that in most cases they won't.

In short, the regulators have failed to face up to the realities of the problem. While the banks have roared forward and while the consumer has been left in a sea of confusion about government insurance, the regulators continue to encourage questionable practices by the banking industry -- dangerous practices that put hard-earned savings of consumers at risk -- when the consumers had no intention of placing their funds at risk.

Caught playing fast and loose with the Government's insurance the banking industry is rushing its lobbyists to Capitol Hill and to the media in an attempt to convince everyone that the answer is "self-regulation".

Clearly, the Congress is the last best hope for the consumers of banks are to be prevented from using the FDIC insurance and logo as a tool to fool consumers.

NEED FOR CONGRESSIONAL ACTION

Congress created the deposit insurance system and has an obligation to enact safeguards that protect not only the customer, but the integrity of the FDIC shield.

Thanks to Congress' support of Federal deposit insurance, consumers don't think twice about the safety of savings once placed in the hands of a banker.

It is the Congress that must take responsibility and enact legislation that will ensure that there can be no commingling -- in practice or perception -- of insured and uninsured activities of banks.

The hard simple fact is that too many American consumers do not understand that investment products -- like mutual funds and annuities -- sold by banks are not guaranteed by the Federal government.

We believe that the Congress must act swiftly and not wait for the rude awakening of a stock market "correction" to enact safeguards to protect consumers against misleading marketing efforts by FDIC-insured institutions.

Consumers need four key protections:

(1) an insured institutions's name and logo must be separate from the label of an uninsured product;

(2) the location of insured activity within a bank must be clearly separated from the location of the marketing of uninsured products;

(3) bank employees who handle insured funds must be separate and distinct from those that peddle uninsured products; and,

(4) consistent functional regulation of the securities activities of insured institutions.

Before banks expand further into the mutual fund market in any manner -- including the pending application by Mellon Bank Corporation to acquire the Dreyfus Corporation -- protections must be in place that will make certain that there is no misunderstanding in the public's mind about banks being some kind of "risk-free" zone for mutual funds.

COMMENTS ON H.R. 3306.

Until proven protections are in place, we believe that it would be reckless to add to the problem by allowing banks to expand further into the securities business. There is a very serious

problem in the market place. The industry and its regulators should get it right before letting banks further expand into the securities business.

This is why, Mr. Chairman, we believe a full moratorium should be placed on expansion of bank operations in the mutual fund business until:

(1) the Congress has a chance to enact statutory safeguards;

(2) the regulators come up with consistent, coordinated and proven approaches to the problem; and,

(3) the banking industry, itself, gets its act together and agrees to eliminate practices -- however subtle or overt -- that permit visions of government insurance standing behind mutual funds to dance in the public's mind.

CFA is pleased that Chairman Gonzalez of the full Committee and Congressman Schumer have recognized the seriousness of the need for solid consumer safeguards in bank sale of uninsured products and have introduced legislation to address some of these problems.

H.R. 3306, the "Depository Institutions Retail Investment Sales and Disclosure Act", would establish basic standards for bank sales of uninsured investment products. The proposed legislation would require plain-English disclosure of the risk associated with investment products; the separation of personnel handling and the location of the sale of insured and uninsured products; and, a prohibition on the use of confidential consumer information without the customers prior written consent.

These are important steps. But, CFA believes that more is necessary to correct problems of deceptive marketing and consumer confusion. We believe that the legislation must be improved in the following areas:

1) There must be a complete ban on the use of similar names or logos by an insured bank and its uninsured securities affiliate;

2) <u>All</u> persons who sell securities investments must be SEC registered;

3) The use of testers by regulatory agencies should be a mandatory element of every compliance program;

4) Compensation by commission should be prohibited for all sale of uninsured investments to bank customers;

5) Consumers should be granted a "cooling-off" period of not less than 7 days during which they could rescind an investment decision without penalty; and,

6) Finally, we believe that the legislation should provide for the functional regulation of bank securities activities and thereby more fully close the gaps that exist in consumer protection in the investment market place.

CONCLUSION

The mixture of commercial banking and investment banking raises a multitude of questions about conflicts of interest, safety and soundness and consumer protection.

While the Congress, the regulators and the industry continue to debate how far banks should reach into the securities business, the Congress has a clear obligation to provide consumer protections up front -- safeguards that will prevent FDIC logos and insurance from being transformed from symbols of personal and financial safety into deceptive marketing tools for bank-sold securities.

SHOULD YOU BUY MUTUAL FUNDS FROM YOUR BANK?

Illustration by Michael Witte

Our investigation of 40 banks in five states found bad investment advice and outright lies about safety.

Some 3500 banks across the U.S. now sell mutual funds. And many of those banks sell them aggressively. Through the third quarter of 1993, the money invested in bank mutual funds was growing 40 percent a year—almost twice as fast as the fund industry in general.

Banks aren't just selling mutual funds. They're also advising customers on what to buy. Banks may sell funds from an independent company such as Fidelity, Colonial, or Franklin. Or, as about 125 banks now do, they may offer their own line of mutual funds.

For this report, we put the banks' recommendations to the test. A CU reporter, representing himself as a customer with money from a maturing certificate of deposit to invest, sat down with 40 investment salespeople at banks in California, Connecticut, Illinois, New Jersey, and New York. He found that although banks endow their salespeople with authoritative titles—"investment counselor," "financial planner," and the like, customers rarely get a detailed, thoughtful, appropriate financial plan. The investment advice our reporter received was often inappropriate, sometimes wildly so.

The big picture

Our reporter gave each bank's salesperson the same basic set of facts. He had $50,000 in CD money coming due and didn't know much about investing. He did not say that he was conducting a survey.

As a group, the salespeople stumbled badly on the basics. At a minimum, an investment adviser needs to know something about the level of risk that a client is comfortable with. But only 16 of the 40 salespeople bothered to ask any questions that would have led in that direction. On the occasions when he was asked, the reporter portrayed himself as a conservative investor who wanted to get a bit more than prevailing CD rates without taking any chances. To their credit, the salespeople who went to the trouble to probe generally made appropriate investment recommendations.

Of the 24 salespeople who didn't ask about risk, two-thirds made recommendations that included a substantial investment in aggressive-growth stock funds. Such funds are among the most risky investments; the possibility of losing money, at least over the short term, is high. Whatever their long-term potential, they are inappropriate for anyone who shuns risk.

Half of all the salespeople also failed to ask what other investments the reporter had. To make an informed recommendation, an investment counselor needs to know what else a client owns in order to get a picture of how risky that client's collective portfolio may be. That's a basic tenet of financial planning.

All told, only six of the 40 salespeople asked for what we would consider essential information and recommended investments that were appropriate, balanced, and relatively low in risk. Such investments might include short-term bond funds, municipal bond funds, asset allocation funds, money-market funds, and perhaps some conservative stock mutual funds. If our six out of 40 salespeople are representative, the odds of getting good advice at a bank that sells mutual funds are worse than 1 in 6.

It's 'guaranteed'

The sales presentations our reporter witnessed were peppered with incorrect and misleading statements. Many of the salespeople represented their investments as a sure thing, whatever those investments turned out to be.

"You'll get 10 percent guaranteed," said a salesman at Chase Manhattan Bank in New York, as he handed over prospectuses for three stock and bond mutual funds. When pressed for details of this guarantee, he retreated to: "Our funds have never lost money over a one-year period." (That's true, although the Chase funds have only been in existence for about five years, not long enough to have weathered a sustained down market.)

About one salesperson in four cited the returns of that bank's mutual funds without including the effect of commissions. One salesman, for example, touted a Government bond fund that he claimed had a one-year return of 8.7 percent. The prospectus, however, showed that after subtracting the commission, the one-year return shrank to just 4.2 percent, about the same as then-prevailing CD rates.

At Shawmut Bank in New Haven, Conn., a saleswoman was mistaken

about even the fundamentals of finance. "Buy bonds if you don't want risk," she said. "All our bond funds are very conservative." In fact, bond funds can be quite risky if interest rates change She also claimed that bond funds were an ideal way to take advantage of rising interest rates. Just the opposite is true. The value of bonds, and bond mutual funds, falls when interest rates rise.

After a lengthy interview, a salesman at First Interstate Bank in Los Angeles recommended three mutual funds. He insisted that the bank's "completely safe" mutual funds would "lock in" a 20 percent gain with "hardly any risk." But the funds he recommended had not returned 20 percent in years past, and they would have to be considered moderate to high in risk.

At Wells Fargo Bank in Los Angeles, the salesman assured our reporter of the safety of the bank's "rock-solid, Government-guaranteed" Treasury bond fund. Indeed, the mutual fund had performed well, but it was plenty risky. The bonds in its portfolio had an average maturity of 25 years; the longer a bond fund's average maturity, the more susceptible it is to interest-rate changes. A mere one percent rise in interest rates will cause a bond with a maturity of 25 years to fall about 12 percent in value.

The Wells Fargo salesman said, "You can't lose money on Government-guaranteed bonds." That's only partly true. While some bonds are Government-guaranteed, that simply means the bonds will be redeemed at their stated value when they mature. It doesn't mean that a mutual fund that invests in them can't decrease in value if interest rates change.

More than a dozen of the salespeople suggested that insurance from the Securities Investor Protection Corp., or SIPC, was just as good as Federal Deposit Insurance Corp. (FDIC) insurance. In fact, the SIPC insures brokerage accounts for up to $500,000 each, but pays off only if the brokerage firm goes bankrupt. The SIPC doesn't insure the performance of investments.

At Union Bank in Los Angeles, a saleswoman skipped mutual funds altogether. She first tried to sell our reporter an annuity, an insurance contract that promises a payment or series of payments at some future date, usually at retirement. When the reporter hesitated, the saleswoman phoned a colleague in another office and handed over the receiver. That salesman pitched a unit investment trust, an investment that's something like a mutual fund but that usually carries a higher commission.

Of the 40 salespeople who offered investment advice, only eight, in our judgment, made a credible effort to explain why they recommended what they did. Some others couched their advice in investment jargon that a customer with no background in finance would have been hard-pressed to understand. At United Jersey Bank in New Jersey, for example, a salesman tossed out such terms as "inverted yield curve," "basis points," "yield to maturity," "long hedge," and "fundamental analysis."

Most of the salespeople either skipped over or downplayed their commissions, which often take four to five percent off the top of a typical mutual-fund investment. Once again, only eight of the 40 salespeople we encountered outlined the fees in a manner that we judged complete and easily understood.

Profiting from confusion

Americans place a high degree of trust in their banks, largely because the FDIC guarantees bank account balances up to certain limits. But a 1993 survey by the Securities and Exchange Commission found that only 33 percent of the consumers questioned knew that money-market mutual funds sold by banks are not protected by FDIC insurance. And 28 percent thought that all mutual funds sold by banks are just as safe as deposits with FDIC insurance. Another 17 percent weren't sure whether bank mutual funds were insured or not. (They aren't. It's possible, if unlikely, to lose every cent that you put into a mutual fund, whether you bought it at a bank or elsewhere.)

It's not surprising that the public is confused, given the expansion of bank services in recent years. Until 1987, banks were mainly limited to taking deposits, paying interest on those deposits, and making loans. Then the Government began to allow banks to sell financial products such as stocks, bonds, annuities, and mutual funds.

Since then, banks have been starting and selling mutual funds at a rapid pace. BayBanks, Inc., of Boston, launched a family of mutual funds at the beginning of 1993, and by fall had attracted over $1-billion in assets. Mellon Bank of Pittsburgh announced in December that it would acquire the $80-billion Dreyfus Corp. mutual-fund company.

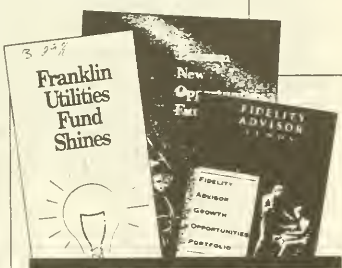
One reason for the banks' interest in funds is that tightened Federal rules on lending and increased capital requirements have forced them to look for sources of revenue other than making loans. At the same time, low rates on certificates of deposit have led to an exodus of depositors' money from banks. Nearly a third of all the money invested in CDs in 1990 has since left—a net loss of $191-billion in 1992 and $84-billion in 1993. Banks that sell mutual funds can keep some of that money from leaving, and they may be able to sell those customers CDs again if interest rates rise.

Enter the regulators

No branch of the Federal Government has been eager to claim jurisdiction over bank sales of uninsured investments. The Securities and Exchange Commission, which oversees other types of mutual funds, hasn't claimed direct regulatory power over those sold by banks. The FDIC and the Comptroller of the Currency both say their main concern is that banks not imply that their mutual funds and other investments are FDIC-insured.

There are signs that the Government may be waking from its regulatory slumber. Last November, President Clinton proposed a plan to consolidate oversight of the banking industry under a single Federal board, rather than the four agencies that currently share responsibility. Lax regulation of bank sales of in-

Growth industry Banks currently offer more than 1150 mutual funds with nearly $200-billion in assets. That's up from 213 funds and $35-billion just five years ago.



Game of percentages Fund companies must follow strict rules in quoting their past returns to potential investors. Not so the bank salespeople we encountered. Some took the liberty of writing the percentage rates they predicted on the fund literature they gave our reporter

✓ Quart of milk
✓ Loaf of bread
✓ Mutual fund
Bank South Corp. of Atlanta, which operates banking outlets in stores like Kroger and Piggly Wiggly, has announced plans to sell mutual funds at its supermarket locations.

vestment products was cited as one reason for such a move.

The FDIC last summer issued an "advisory" to banks on mutual-fund sales. But the advisory, and similar guidelines from the Comptroller of the Currency, are simply advice, not rules. They have been widely ignored by the banks.

The Comptroller's guidelines call for banks to make a "conspicuous disclosure" in a prospectus or advertisement that mutual funds sold by the bank do not have FDIC insurance. Only seven of the salespeople we encountered, however, mentioned that the funds they sold were not bank deposits or were not FDIC insured.

Legislation to rein in the banks has been introduced by Henry Gonzales, D-Tex., chairman of the House Banking Committee. He cited as an example of the potential for abuse the Lincoln Savings & Loan scandal of 1989. It involved thousands of people, most of them elderly, who bought uninsured bonds they believed to be federally insured because the bonds were sold inside the bank. When the savings and loan was taken over by the Government, more than 23,000 customers were left holding $255-million in worthless bonds.

Investigators found that tellers at Lincoln Savings & Loan received bonuses for recommending uninsured bonds to customers and for meeting the sales quotas established at each branch. Customers were not told that the bonds were being used to finance real-estate ventures that entailed considerable risk.

The House proposal would require banks to sell uninsured products in a separate part of the bank. Currently, the regulations merely require them to comply "to the extent permitted by space and personnel considerations." Few of the banks CU visited segregated their mutual-fund operations. Indeed, most of them placed fund representatives in prominent locations, such as near the entrance or the tellers' line.

At some banks we visited, lobbies were festooned with mutual-fund advertisements. The small Wells Fargo branch at the corner of 6th and Grand in downtown Los Angeles featured more than 20 large hanging signs advertising mutual funds. Wells Fargo customers can even make some mutual-fund transactions through the bank's 1700 automated teller machines.

At several banks, our reporter overheard salespeople calling customers whose CDs were about to expire. Those customers were urged to switch their CDs to the bank's mutual funds or other investments. A salesman at a California bank boasted, "When I tell them the kind of return they could get with mutual funds, their eyes pop out."

Marketing efforts that target CD customers "can lead to abuse and therefore are of special concern," says the FDIC. The practice of calling people with maturing CDs to sell them other investments would be curtailed under the Gonzales bill. Prior written consent from the customer would be required before information about his or her accounts could be released without a court order.

The bill would also prohibit tellers from making unsolicited referrals to bank customers. According to the Consumer Bankers Association, a banking-industry trade group, tellers are often given incentives for referring depositors to the investment salespeople. Such incentives may include cash or extra vacation time, according to another source.

Customers usually aren't told whether the salesperson sitting in their bank's lobby works for the bank itself, a subsidiary of the bank, or an outside firm. If those customers buy a fund, their monthly statements may carry the bank's name, but the bank itself may have nothing to do with the investment except to collect a commission.

A bank may not only give an outside brokerage firm space in its branches, it may give the firm access to the bank's customer file, including the expiring CD lists. Bringing in outsiders who are not directly accountable to the bank creates the greatest chance for abuse. A branch manager at a Chicago bank, who asked that his name be withheld, told our reporter that no fewer than 12 brokers had come and gone from his branch during the previous 14 months. "The brokers are on commission, and my customers are marks to them," the manager said. "They don't monitor the customers' portfolio, except to try to generate another commission." ■

ADVICE ON ADVISERS

WHERE TO FIND INVESTMENT HELP

If you are planning to invest in mutual funds for the first time, your best bet is to educate yourself in the basics of investing, not to put your trust or your money in the hands of someone billed as an "investment adviser." In particular, we think you should focus on no-load mutual funds, the kind that are sold directly to investors without any costly sales commissions.

Information on mutual-fund investing is widely available. CONSUMER REPORTS published its most recent Ratings of funds in May (stock funds) and June (bond funds) 1993. Other magazines, such as Business Week, Forbes, and Money, also publish fund data, as do newspapers such as The Wall Street Journal and Barron's. Consumer Reports Books will publish a basic guide for fund investors, The Consumer Reports Mutual Funds Book, in May.

If you find that you need more help in choosing funds, don't sign up with the first adviser you encounter. Sound investment advice may well be as close as your neighborhood bank, but how can you tell?

Unfortunately, the fact that your bank may call its salesperson a financial planner means little. Anyone can hang out a financial planner shingle and offer investment advice. Seven of the salespeople we interviewed claimed to be Certified Financial Planners, which means that they have passed a course of study and received a certificate. Interestingly, none of the seven were among the group of salespeople whose recommendations we would consider appropriate.

Good financial planning should start with a written list of your current assets, debts, and income. The adviser should ask about your goals: when you'd like to retire and with what level of income, how you plan to finance your children's education, your tax situation, and so on.

With those factors in mind, the adviser can present a variety of investments with varying risk levels. He or she should be willing to explain each of them to your satisfaction and to let you choose what's best for you.

Insurance agents, lawyers, accountants, and tax preparers may do financial planning. Speak to several before you hand over any money. Shun those who want you to decide immediately. And don't rely on oral representations—get everything in writing.

If you want to pay for investment advice, consider hiring a fee-only financial planner. Such planners charge by the hour and don't make money from commissions. That doesn't mean their advice will always be better, but at least they won't have a vested interest in selling you the products that make them the most in commissions.

February 14, 1994

Chris Lewis
Scripps Howard News Service
1090 Vermont Avenue, N.W.
Washington, D.C. 20005

Dear Chris:

I have just finished reading your article on banks role in mutual funds sales debated which appeared in The Naples Daily News, on February 13, 1994. In August of 1993 I resigned from Barnett Banks securities division, Barnett Securities Inc. I was Barnett's number one Investment Officer generating over one million dollars in gross commissions and the bulk of that money was directly from the sale of mutual funds. It is true that the majority of bank investors have no clue that their investments are not insured; most have no idea that their government bond funds are not guaranteed by the government as well as not understanding the relationship between interest rates and bond funds. In my opinion, banks biggest debacle will come when interest ate rise and all those bank mutual fund buyers start losing all of their principal. Much of the problem is due directly to being forced to take every client that walks through the door, and as an investment professional having no right to say no to any client simply because they are a client of the bank. It is also a large problem now that banks have their own mutual funds; all of the incentives are tied directly to meeting expected sales quotas and undue sales pressure put on bank reps to sell these less than stellar funds. There is currently underway a move by bank brokers to move back to the full service wall street firms. In the Barnett system alone, which controls more market share than any other bank system in Florida, they have lost at least 10 of their top producers to full service brokerage firms and accounts for well over 500,000,000 million dollars in assets that will follow these highly successful reps.

In making a comparison to the regulations followed by both banks and brokerage firms, there is no comparison... banks have almost no regulation at all. There are no principled managers at the bank offices, reps are left to oversee other reps, bankers with no licensing at all are sending solicitation letters to bank customers to buy bank mutual funds, bankers are paid bonuses for making referrals to the brokers as well as trips are paid as bonuses for making referrals to the brokers as well as trips sponsored by the fund companies to solicit the business of the bank reps.

Annuities are a completely other deal. At Barnett for instance the annuities are not called annuities they are called tax advantaged accounts. They are bank deposits that are run through a trust account and then placed with an annuity company who pays Barnett Bank one million dollars per month for the right to market their annuity through the bank. Most of the investors are not even aware that they own an annuity.

These investments are not sold by any employees of the bank, but are instead sold by what are referred to as a third party vendor who have no allegiance to the bank what so ever.

I think that you have not even touched the tip of the iceberg when it comes to protecting the interests of the bank consumer. I do hope that for the benefit of all of these unsuspecting older Americans you are able to continue in your efforts to make banks answer to the same powers that be, in the securities industry...

Thank you,

[redacted]

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

NASAA

One Massachusetts Avenue, N.W., Suite 310
Washington, D.C. 20001
202/737-0900
Telecopier: 202/783-3571

STATEMENT OF
PHILIP A. FEIGIN
Securities Commissioner, Colorado Division of Securities
President-Elect, North American Securities Administrators Association

on behalf of the
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND DEPOSIT INSURANCE
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

THE SALE of MUTUAL FUNDS BY BANKS and H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act

March 8, 1994

Mr. Chairman and Members of the Subcommittee:

The North American Securities Administrators Association (NASAA) appreciates the opportunity to submit to the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance comments on the very serious consumer protection issues that arise from the sale of uninsured investment products on bank premises.[1] In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

As you may know Mr. Chairman, the primary function of state securities regulation is the protection of small investors from fraud and abuse in the capital markets. As a result, we see the day-to-day implications of what at times may be thought of on the national level only in theoretical terms, or worse yet, dismissed as mere "turf battles."

Today, state securities regulators across the country are reporting mounting evidence of consumer confusion about the insurance coverage, the risks, and the fees associated with the sale of uninsured products sold on bank premises. This is not to say that NASAA is opposed to the sale of uninsured products on bank premises. In fact, it is the Association's position that banks are now another option for consumers who have money to invest in mutual funds, stocks and annuities and understand the risks in doing so. Our goal is to make sure that there is no "consumer protection gap" in relevant regulation.

An informal look by several states at what is actually going on in bank lobbies makes it very clear why consumers are so confused: the marketplace is sending them a bewildering variety of mixed, garbled and misleading messages. Among the problems uncovered by states at the banks were: a blurring of the distinction between traditional bank activities and the sale of uninsured products; inadequate or misleading disclosure; and a serious gap in the consumer protection available to consumers who purchase securities on bank premises.

A more comprehensive look at the ramifications of this issue on the individual level may be found in the national opinion survey released in January by NASAA and the American Association of Retired Persons (AARP). What this survey revealed was that the vast majority of American bank consumers are unaware of the risks and fees involved in the uninsured investment products, such as mutual funds and annuities, that are now increasingly available at U.S. banks and other financial institutions. The survey data indicate that fewer than one in five bank customers knows that mutual funds (18 percent)

---

[1] For purposes of simplification, the term "bank" is used throughout this testimony to refer to financial institutions generally, including thrifts, savings and loan associations and credit unions.

and annuities (14 percent) are not insured by the Federal Deposit Insurance Corporation (FDIC). The survey also found that a substantial number of Americans are: unsure about the risks involved in such investments sold at banks; not questioned about the appropriateness of these investments for their needs; and unaware of where to turn for regulatory help in the event they have a problem with an uninsured investment purchased at a bank.

What state securities regulators see in these numbers is a distressing pattern of confusion and false comfort on the part of bank customers, a very substantial portion of whom do not seem to grasp the fact that banks have moved beyond their narrow and traditional business of selling only FDIC-insured products. When the next market correction takes place, millions of U.S. consumers may end up learning the hard way that there is no safety net for mutual funds and stocks sold at banks.

We know what happened with the outpouring of consumer panic and distrust in the wake of 1987's "Black Monday." At that time, most of the backlash was focused against brokerage firms and investment companies. Now banks have opened themselves up to the same reaction from the public. As a result, this is more than just a matter of concern for consumers; this is something that has the potential to emerge down the road as a real test of the public's perception of the safety and soundness of banks.

It is NASAA's view that the time has come for federal legislation to address comprehensively the interrelated issues of securities activities conducted on bank premises and the safeguards needed to protect investors. It is abundantly clear that banks already are in the securities business in a major way. Recent events have served to underscore and to bring into focus the concerns expressed by NASAA and its members about the steadily increasing role of banks in the securities markets and the lack of legally-mandated investor safeguards. This is a situation that should not be allowed to go on in an "ad hoc" fashion.

The simple fact is that the laws and regulations governing the activities of financial institutions have not kept pace with the dramatic changes in the marketplace. While there have been serious efforts over the years to rationalize the oversight of the new bank activities, we nonetheless are left today with a regulatory system that defies common sense, is wholly inadequate, and potentially could result in a serious and devastating loss of consumer confidence. NASAA respectfully urges Congress to move swiftly to ensure that this nation's financial system is one that inspires consumer confidence and operates as efficiently and safely as possible.

NASAA supports the adoption of federal legislation in which it is recognized that special circumstances arise when uninsured products are sold at banks that have spent many decades persuading consumers to trust them because of the FDIC protection available for their traditional deposit products. At the same time, state securities regulators --

individually and collectively through NASAA -- are reviewing the adequacy of state securities laws, regulations and enforcement programs with respect to the activities of brokerage firms operating on bank premises. NASAA also is working with representatives of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) to determine how we may best work together to protect consumers who purchase investment products on bank premises.

THE EROSION OF GLASS-STEAGALL BARRIERS

The issue of whether commercial banks should be allowed to tap into new sources of business, including the sale of uninsured products on bank premises either directly or indirectly, is no longer an academic question. The fact is that many of the restrictions on the securities activities of banks erected by Congress in the Glass-Steagall Act[2] have been eroded or removed through judicial and administrative decisions[3], thereby allowing banks and their non-bank affiliates to participate in a broad range of uninsured investment-related activities.

The regulatory and court decisions creating loopholes in the Depression-era law banning banks from the securities business have been in place for several years now. It has only been recently that low interest rates have prompted the explosive growth in the sale through banks of uninsured products. As these low interest rates have propelled consumers to search beyond traditional bank savings products for better returns, more and more banks have moved to offer their clientele a wider range of financial products. Mutual funds, popular with consumers for a number of reasons, are one of the investment alternatives that many banks are providing in their bid to retain customer assets and generate new sources of revenue.

Banks are now major participants in the securities markets and it is likely that their involvement will continue to grow as bank customers move away from insured deposits into mutual funds and other uninsured products. Today, about one-third of all mutual funds are available through the bank channel.[4] Why are banks expanding beyond their traditional base and moving into recommending or selling to retail customers non-deposit

---

[2] Banking Act of 1933, 48 Stat. 162-95 (codified as amended in various sections of 12 U.S.C.).

[3] For example, the Office of the Comptroller of the Currency has used the "incidental powers" clause of the National Bank Act to allow national bankers to engage in certain activities once considered the exclusive territory of investment and insurance firms. The Federal Reserve has used the "closely related" language of the Bank Holding Company Act to expand the permissible product and service lines for bank holding companies.

[4] "Fundamentals," Mutual Fund Research in Brief, Research Department, Investment Company Institute, May 1993.

investment products, such as mutual funds and annuities? It may be because selling investment-related products can be a profitable business and, significantly, a growth business at a time when banks are suffering a steady erosion in their traditional product base. Banks are not only anxious to retain customers in search of higher returns, but they also are eager to tap into the growing consumer demand for mutual funds and other investments.[5]

While mutual funds may be the investment product of choice today, we should not assume that banks will limit their activities to such a narrow range of activities in the future. Nor should we dismiss concerns about the potential for consumer harm based on the fact that banks now involved in the sale of uninsured products generally have limited their activity to mutual funds. As one industry observer so aptly cautioned, " ... the 'rising tide' in mutual fund sales has masked the fact that the mutual fund business is not immune from downturns ... ."[6] I cannot help but wonder what we would be facing today in terms of a banking crisis if banks had gotten into the securities business a decade ago when the "hot" investment product was limited partnerships, which at the time were thought of by investors as good, relatively safe, stable long-term investments and have since gone sour on a colossal scale.

THE SALE OF UNINSURED PRODUCTS ON BANK PREMISES: THE BIGGEST CONSUMER AWARENESS PROBLEM IN AMERICA TODAY?

It was late last summer when NASAA and AARP first discussed the need to gather additional information about what appeared to be widespread customer confusion concerning the sale of uninsured investment products on bank premises. We agreed that in order to formulate specific policy recommendations, we would need to know more about the level of consumer understanding of the risks involved in purchasing uninsured products through banks and more about how it is that banks are conducting their investment-related activities.

---

[5] For example, according to data gathered for Money magazine's "Small Investor Index," from January 1, 1993, to November 1, 1993, bank depositors reportedly withdrew about $77 billion from certificates of deposit and reinvested most of the proceeds in stock and bond mutual funds. (Jordon Goodman, "Depositors Switch Billions from CDs to Mutual Funds," Money, December 1993.) To be sure, not all of the money going into bank mutual funds is coming from maturing CDs. In fact, money from maturing CDs accounted for only about 5.5 percent of the individuals who invested in stock or bond mutual funds from July 1991 to July 1993. The bottom line is that the money flowing into mutual funds is coming from more sources than just maturing CDs. (Stan Hinden, "Some Wrongs That Have Become Rites," Washington Post, November 17, 1993, p. G3.)

[6] Matthew Fink, Investment Company Institute, "Rough Weather Ahead for Banks in Mutual Funds," American Banker, February 17, 1994, p. 29.

What we found in a nationwide survey is that the vast majority of American bank customers are unaware of the risks and fees involved in the uninsured investment products, such as mutual funds and annuities, that are now increasingly available at U.S. banks and other financial institutions.

KEY SURVEY FINDINGS

The survey released on January 13, 1994, by the AARP and NASAA was conducted by Princeton Survey Research Associates of Princeton, New Jersey. The results were based on telephone interviews with a representative sample of 1,000 adults living in the United States who reported making financial decisions for their household and also reported using a regular commercial bank.[7] One quarter of the commercial bank customers also use a mutual fund company and one in five (21 percent) use a brokerage company.

Major results of the NASAA/AARP survey include the following:

o **The vast majority of bank customers are unaware that mutual funds, stocks and annuities sold at their banks are not insured by the FDIC program.**

> Fewer than one in five commercial bank customers understands that mutual funds (18 percent) and annuities (14 percent) are not FDIC insured.
>
> Only one quarter (25 percent) of customers at banks where stocks are sold know that these products are uninsured.
>
> About two in five customers think mutual funds (39 percent) and annuities (40 percent) sold at banks are FDIC insured. Another 43 percent do not know whether such mutual funds are insured, and 46 percent are unsure whether annuities sold at their banks are insured.
>
> A third (35 percent) of the customers at commercial banks where stocks are sold think these purchases are FDIC insured, and another 40 percent are unsure.

o **People who have actually purchased mutual funds or annuities at their bank are no better informed about the risks associated with such investments than are other bank customers.** In fact, these purchasers are even more likely than

---

[7] Interviews for the NASAA/AARP survey were conducted during the period October 14-October 31, 1993. The margin of error for the total sample of 1,000 commercial bank customers is plus or minus 3 percentage points at the 95 percent level of confidence. The margin of sampling error for results based on a subset of the total sample is larger.

other bank customers to think the FDIC program covers their investment in a mutual fund or annuity sold at a bank.

About half of the people who purchased a mutual fund (52 percent) or annuity (55 percent) at a bank think the purchase was FDIC insured. This compares to 39 percent and 40 percent of all bank customers who think mutual funds and annuities sold at banks are FDIC insured.

Over a third of those who purchased a mutual fund (36 percent) or an annuity (38 percent) at a bank say no one talked with them about the appropriateness (or "suitability") of their investment.

o **Most people who have purchased mutual funds at their bank are also confused about the costs and fees associated with these investments.**

Only 36 percent of mutual fund buyers think they pay a front-end sales load, even though many mutual funds sold through banks involve such a charge.

More than half (54 percent) either believe that there is no redemption fee associated with their mutual fund or are uncertain about the applicability of such a fee in relation to their investment.

In general, a quarter to a third of all those buying mutual funds at a bank do not know if there is a front-end sales load, redemption fee or other management cost associated with their mutual fund.

o **So, even though banks provide their customers with written disclosure documents about uninsured investments, the material is apparently not effective in communicating important details about the risks and costs of these investments.**

Most purchasers of mutual funds (85 percent) and annuities (63 percent) sold at banks say their bank provided them with a disclosure document about their investment.

Most who remember receiving this information also remember taking the time to read it (86 percent of mutual fund buyers and 77 percent of annuity buyers).

- **Bank customers trust their banks and rely upon them to provide good information.**

  Almost nine out of ten (88 percent) bank customers feel they have always received accurate information from their banks about the risks of investing. Only four percent believe that they have been misled or misinformed.

  Only five percent would contact a government agency for help in resolving a problem with an uninsured investment purchased through a bank. Most (82 percent) would try to resolve the problem by contacting someone at the bank.

- **Bank customers admit they are less secure in their understanding of the risks in investments than they are about other details of banking.**

  Large majorities say it is easy to understand the fees and rates their bank charges (82 percent) and the regulations that apply to different bank accounts (75 percent).

  However, considerably fewer bank customers (57 percent) say it is easy to understand the financial risks involved in making different kinds of investments through their banks.

- **Uninsured investment products sold at banks are marketed more aggressively to older Americans.**

  While only about a third (34 percent) of all bank customers have been contacted by their banks about investing in mutual funds, 47 percent of those aged 65 and above have been marketed to in such a fashion.

- **There are pockets of "below average" understanding of the financial risks involved in bank-sold investments.**

  Men are twice as likely as women to know that stocks, mutual funds and annuities are not FDIC insured. For example, 29 percent of men know that mutual funds are not FDIC-insured compared to only 10 percent of women. On stocks, 39 percent of men know they are not FDIC insured, compared to 15 percent of women. Five percent of widowed or divorced women realize that stocks offered by banks are uninsured.

  Even though low-income Americans (making $20,000 a year or less) are almost as likely as higher-income Americans to buy mutual funds, stocks and annuities from banks, they are considerably less likely to know that

> such products are not FDIC insured. Only seven percent of low-income bank customers know that stocks and mutual funds are uninsured. Just four percent are aware of the uninsured status of annuities. Though awareness of the limits of FDIC coverage rises somewhat with income and education, considerable confusion is evident even among Americans with the most wealth and schooling. For example, only 33 percent of those making $60,000 a year or more think that mutual funds sold by banks are not FDIC insured. Just 21 percent of those with a college education think that annuities sold at banks are not FDIC insured.

The NASAA/AARP findings are consistent with the results of a similar, but narrower public opinion survey released in November 1993 by the U.S. Securities and Exchange Commission that focused on consumer beliefs about FDIC coverage of uninsured investments at banks.

What concerns state securities regulators is that more and more we will see the financially unsophisticated consumers -- those who are the least able to recognize sometimes subtle distinctions between bank products -- targeted by bank promotional campaigns. A study by financial researcher Phoenix-Hecht showed that about 20 percent of all newcomers to mutual funds make their purchases through banks. Larry Cohen, a vice president of Phoenix-Hecht, observed that novice investors are drawn to banks partly because of familiarity with the institution.[8] A study released in 1988 by the Market Facts research firm concluded that "... banks will succeed in the sale of nontraditional banking products only by focusing on unsophisticated buyers, often first time investors."[9] The authors of the report advised banks to go after the bread-and-butter customers, the "ones who are confused and a little distrustful of financial products."[10]

What is significant in this context is that banks are continuing to find ways to benefit from what may be the most important thing they still have going for them -- trust. Surveys show that people continue to have more confidence in banks than other financial institutions.[11] That trust, of course, is rooted in one basic fact: money placed with a

---

[8] Kalen Holliday, "Banks Keeping Up in Race to Lure New Investors," American Banker, December 22, 1993, p. 16.

[9] Lawrence A. Darby, "To Market New Products, Target the Confused Buyer," American Banker, April 26, 1990, p. 4.

[10] Ibid.

[11] Jerry Knight, "Banks Becoming Financial Supermarkets," Washington Post, August 23, 1993, p. A1. Barry Barbash, Director of the Securities and Exchange Commission's Division of Investment Management, commented on the results of the focus group sessions being conducted by the SEC and the Office of the Comptroller of the Currency to gauge how well consumers understand the differences between mutual funds

bank comes with the federal government's guarantee that it will always be there, even if the bank fails. Although the government insurance does not extend to investment-related products sold on bank premises, that fact is so often downplayed or completely omitted that it not surprising that consumers are confused. Even more disturbing is the misleading way in which some banks and securities brokerage firms are characterizing the insurance coverage of the Securities Investor Protection Corporation (SIPC) as analogous, if not better(!), than FDIC coverage.[12]

While misleading or inadequate disclosure is a problem in this connection, so too are identical or similar names. The reasoning behind common or similar names appears to be simple: a bank's name can be a powerful draw in a local market. A good example of how it is that banks trade on the trust they have built up may be found in the case of the Minnesota bank that was planning to put financial planners in several branches. The bank decided to identify the planners as employees of the bank's brokerage affiliate (which had a name similar to that of the bank) because a pilot program revealed that bank customers were more comfortable when they believed that the planners were affiliated with the bank.[13]

---

and insured deposits: "One thing that comes clearly out of the focus groups is that bank depositors really do think of banks as bastions of safety." (Debra Cope, "Regulators Probe Public's Knowledge of Fund Risk," American Banker, January 27, 1994, p. 16.)

[12] The Securities Investor Protection Corporation (SIPC) is a nonprofit membership corporation, funded by its member securities broker-dealers. SIPC does not protect investors against losses from the rise or fall in the market value of specific investments. What it does is provide protection against certain losses if a SIPC member fails financially and is unable to meet obligations to its securities customers. For example, an investor owns $25,000 worth of shares in ABC corporation and the shares are being held by the broker-dealer for safekeeping or for other purposes. In addition, the investor has $10,000 in cash on deposit with the broker-dealer for the purpose of purchasing additional securities. If that broker-dealer fails financially, the investor will receive all the securities registered in his or her name that were being held by the broker-dealer (which in this case is $25,000 worth of ABC corporation stock), and the $10,000 in cash. Customers may receive up to a maximum of $500,000, including up to $100,000 on claims for cash. On the other hand, that same investor would not eligible for SIPC protection if he or she experiences losses in the investment account due to the rise and fall in market value. (See, How SIPC Protects You, a 1992 publication of the Securities Investor Protection Corporation, Washington, D.C.)

[13] Karen Talley, "First Bank System to Place Financial Planners in More Branches," American Banker, October 27, 1993, p. 17.

CAPITALIZING ON CONFUSION: A LOOK AT BANK SALES PRACTICES

An informal state-level[14] look at the marketing, promotional and sales activities at banks offering uninsured investment products provides startling anecdotal evidence that may help explain why it is that there is widespread consumer confusion and misunderstanding about the risks and fees associated with these products now widely available through banks. What state securities regulators uncovered in their visits to bank lobbies is a marketplace rife with misleading advertising and promotional materials, a systemic breakdown in the distinction between traditional insured activity and the sale of uninsured products, and a serious gap in the consumer protections available to those who purchase investment products on bank premises.

Below are illustrative examples of what state securities regulators found in each of the following major areas of concern: (1) suitability/risk disclosure; (2) misleading references to FDIC and SIPC coverage; and (3) a blurring of the distinctions between bank activities and brokerage activities, including the use of similar or identical names.

SUITABILITY CONCERNS/RISK DISCLOSURE

o An elderly Washington state resident complained to the Washington state Securities Division that she was misled by a **Tacoma, Washington** bank when she was persuaded to put funds from a maturing certificate of deposit (CD) into a mutual fund. The woman, a Yugoslavian immigrant, had intended to withdraw the funds from the maturing CD and take the money to another bank paying a higher return. When bank personnel learned this, they suggested that the depositor could earn a higher return by putting her money in a "government fund." When the woman asked whether the account would be FDIC insured, she was told that it was a secure investment because it was a government fund. She was told that the return would be significantly higher and that there would be no risk. The bank customer was not advised that this was an uninsured investment account rather than a traditional bank deposit account. The receipt she was given had the bank's name on it, as did the customer account form. There is no mention on any form that the money was being put into an uninsured investment product. It was only when a broker contacted her nearly two years later to advise her to withdraw her funds from the account because she was losing money that the woman learned

[14] Twenty state securities agencies contributed information used in developing this testimony. The states include: Arkansas, Colorado, Georgia, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Missouri, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, South Carolina, Texas, Vermont, Washington state and Wisconsin. The state securities divisions were contacted in mid-February and asked to provide us with information on hand or to go into the banks in their area to gather information on the marketing, promotional and sales activities taking place.

that her money -- which represented her life savings -- had been put in a uninsured investment product and that the principal of her investment had been reduced by nearly $12,000. When the customer went to the bank to complain, she learned that the assistant branch manager for the bank was the very woman who sold her the investment product and claimed that it was safe! (The assistant manager admitted that she was not licensed to sell securities at the time she sold the mutual fund to the woman in question, although she claims she could "offer" securities at that time. She apparently now is licensed as a securities broker, as well as continuing to serve as the assistant branch manager for the bank.)

o The Colorado Division of Securities received a complaint from the daughter of an 80-year old widow who had been contacted by her **Denver, Colorado** bank (with which she had done business for 20 years) about investment products at the time her CD was maturing. The widow, an East German emigree, was told she could earn better interest rates if she moved her funds from the CDs into a mutual fund account. The woman later learned that it was not bank personnel she was dealing with when she was persuaded to put her funds in mutual funds, but rather a brokerage firm that has a percentage-lease relationship[15] with the bank. This 80-year old woman's life savings were put into a load mutual fund that had about $4,000 in fees. Despite her complaints about suitability, the woman was told that because she signed all the proper forms, there is no avenue of redress. After considerable and persistent efforts on the part of the woman, the bank ultimately made her whole.

o A retired **Crystal, Minnesota** man on a fixed income was invited to his local bank to discuss options when his CD was about to mature. When the man went to the bank for the meeting, he was unknowingly directed by bank employees to speak to an investment sales representative and not a bank employee. During the meeting, it was suggested that the funds be placed in an investment vehicle that would pay a higher rate of interest than the CD, and would be equal to a CD in terms of safety and liquidity. When the man explained that he was not at all interested in any stock deal, he was reassured that what he was getting into would be very similar to the CD. Ultimately the man agreed to put his funds in what turned out to be a limited partnership that, contrary to the assurances, paid lower interest and was not at all liquid. The retiree explained that he had signed the necessary disclosure forms but that he was not given an opportunity to read them, nor was he provided and explanation of what he was signing. The limited partnership prospectus did not arrive at this home until several days after he had made the investment. Although the gentleman later learned that he was dealing with a representative of the brokerage firm affiliated with the bank, at the time he

[15] Under such an arrangement, a bank leases space on its premises to a third-party broker-dealer and the bank receives a percentage of the gross sales commissions.

believed he was dealing with representatives of a bank he had grown to trust. The customer claims that there was no physical separation between the banking and brokerage activities and that there were no posters or other signs that would alert someone they were no longer dealing with a bank representative.

MISLEADING REFERENCES TO FDIC/SIPC COVERAGE

o The promotional materials for the brokerage services of a **Wichita, Kansas** bank suggest that *"All securities in your Brokerage Account are protected by the Securities Investors Protection Corporation for up to $500,000 (limited to $100,000 for claims for cash)."* Customers may mistakenly -- but understandably -- read that statement coming from a bank to mean that the "protection" works in much the same manner as FDIC insurance. Brochures in the bank lobby describing the investment-related services of the brokerage unit failed to include any mention whatsoever that these products are not FDIC-insured.

o The back panel of a brochure promoting the brokerage firm (which uses the word "bank" in its name) affiliated with a **Denver, Colorado** bank describes the uninsured nature of investment products in this manner: "_____ *Securities Corporation is not a bank and* ***some*** *of the investments it makes available are not obligations of, or guaranteed by a bank, nor are they insured by the FDIC."* (Emphasis added.) Another brochure put out by the same brokerage firm includes the following "disclosures," which takes the FDIC/SIPC confusion to the worst extremes uncovered so far:

> ***You have access to a variety of safekeeping services.*** *Securities held in your investment account are covered up to $10,000,000 of protection, as detailed in the box below.*

Protection Insurance
SIPC
(Securities Investor Protection Corporation) --
(Including $100,000 in cash)
up to $500,000

Equitable Casualty and
Surety Company
$9,500,000

Total Coverage **$10,000,000**

- o When asked about government insurance on a mutual fund, a sales representative operating in the lobby of a **Boston, Massachusetts** bank said that a mutual fund was as safe as a CD. The representative added that the mutual fund is safer in some respects because a "an investment in a fund is protected by SIPC up to $500,000, while a CD is only protected up to $100,000." When asked if SIPC was a federal agency like the FDIC, the representative said "no," but that it provided similar protection.

- o Slick promotional materials for the brokerage affiliate of a **Kansas City, Missouri** bank omit entirely any discussion of the lack of FDIC insurance for these products. The brochures appeared in a bank lobby.

- o Brochures promoting the services of a **Lincoln, Nebraska** bank include "Investment Alternatives" under the general heading of "Savings Plans." Although there is a one-line, fine-print sentence indicating that investment products are not FDIC insured, an open panel on the back of the brochure reads "FDIC INSURED" in a general way. If the customer sees the cover, the first panels of text and the back of the brochure, the message certainly would be that the products carry FDIC insurance.

- o The brochure for the brokerage affiliate of a **Little Rock, Arkansas** bank advertises its investment-related services and prominently discloses the brokerage's ties to the bank. In fact, the bank name and logo appear in large print, as does the "Member FDIC" notice. Nowhere on the brochure is it stated that FDIC coverage does not extend to investment products.

BLURRING THE DISTINCTION BETWEEN BANKING AND BROKERAGE ACTIVITIES

- o An **Arlington, Virginia** bank uses the same logo and a nearly identical name for both its traditional banking and its uninsured investment sales operations. Additionally, the bank logo is imprinted on all of the inserts in a brochure detailing the banking, insurance and investment services of the institution. Brochures for both insured and uninsured products are commingled in the bank lobby and large posters just a few feet from the tellers' windows advertise the availability of the investment products. The lobby posters do not disclose the uninsured nature of these investment vehicles.

- o A **Maine** investor did business with a brokerage firm operating out of a bank lobby and using a name identical to that of the bank. He did not understand the difference between dealing with a bank and a securities firm. In his complaint to state regulators, the investor made repeated reference to what "his bank had done to him." His dispute actually was with the brokerage firm and involved the fees

associated with a municipal income fund he purchased after cashing in his certificates of deposit.

o Customers of a **Topeka, Kansas** bank may understandably be confused by the promotional materials for the affiliated brokerage firm that goes by an identical name, has the same logo and uses exactly the same artwork as the bank.

o Examiners from the Colorado Securities Division illustrated the blurring of the lines between banks and brokerages and the concerns about inadequate disclosure in a report describing the various signs in a **Denver, Colorado** bank lobby. For example, in the area of the bank where investment sales representatives were located there was a small sign signifying "NASD member" and "SIPC." There were no signs indicating that the products being made available by the brokerage firm were not FDIC insured. In addition, a "State of Colorado Charter Bank" sign was displayed on the table immediately adjacent to the investment sales representative's desk.

o A **Boston, Massachusetts** bank and its brokerage affiliate share an identical name and logo that is printed on the front cover of prospectuses for uninsured investment products. Brochures available in the bank lobby contain inadequate disclosure with respect to the risks associated with investment products and no information discussing fees is made available. Finally, there is no physical separation between the investment sales representatives and the bank's customer service personnel. There are no signs that would distinguish the investment and banking-related services.

o A newspaper advertisement for the investment center affiliated with a **Topeka, Kansas** bank reads *"Alternative Investments Are Now Available Where You Bank."* Readers are advised that they may call a bank representative who will set up an appointment with the investment executives. The ad directly equates traditional investments (e.g., savings, CDs, etc.) with uninsured products, making them appear to be merely different alternatives.

o The securities arm of a **Denver, Colorado** bank makes available to customers a brochure that asks:

Why Talk to ____ about my investment needs?
A Reliable Financial Planner

> *For three generations ____ has enjoyed the reputation of being a premier financial institution. We have been satisfying financial needs with products such as checking and savings accounts, loans and CDs. But, did you*

know we also provide personal professional investment service through (name of brokerage firm)?

The return card asks consumers to indicate whether they are customers of the bank and, if so, what branch they most frequently visit.

o A newspaper advertisement running in papers in **Little Rock, Arkansas** displays the names of several big brokerage firms and then asks the reader: *"Which Brokerage Firm Also Offers the Unique Insight of Arkansas' Largest Bank?"* In the text of the ad it is asserted that the brokerage firm in question has not only the expertise and capacity of any national brokerage firm, it is also the "only firm" to offer the "service, convenience and unique insight of the region's premier banking organization." Readers are encouraged to find out "how a regional bank can meet your investment needs on a national scale."

ACTUAL BANK SALES PRACTICES: WHAT SURVEYS SHOW

While many states have visited bank lobbies over the last several weeks to gain a better understanding of how it is that banks are promoting their brokerage activities, the Texas State Securities Board and the New Jersey Bureau of Securities each conducted very similar informal surveys during February 1994.[16] It is instructive to look at the results of the surveys conducted in these two states and to compare those findings with what was uncovered in a Consumer Reports[17] investigation of 40 banks in five states.

The nearly identical results of these three independent surveys go a long way in explaining why it is that consumers are confused about the uninsured nature of investment products and the risks and fees associated with them.

The results of the survey are shown are the following page.

---

[16] Examiners from the Texas State Securities Board targeted three general geographic regions and, posing as potential customers, requested information on uninsured bank products. The geographic regions were Houston/La Grange, Austin/Georgetown/San Antonio, and Dallas/Irving. In total, 30 banks were visited. The New Jersey Securities Bureau visited a total of 18 banks in Bergen, Middlesex, and Morris counties.

[17] "Should You Buy Mutual Funds From Your Bank?" Consumer Reports, March 1994, pp 148-150.

ISSUE	TEXAS	NJ	CR
Banks offering investment products	80%	72%	100%
Banks with a visual display disclosing investment products are not insured	25%	0%	---
Banks in which the insured and uninsured activities are physically separated	41%	57%	"few"
Banks in which risk and suitability issues were discussed in presentation	50%	14%	15%
Banks in which potential loss of principal was discussed	29%	42%	18%
Banks in which fees were discussed	---	33%	20%
Banks in which dual employees or bank personnel made investment presentation	20%	---	---

CLOSING THE CONSUMER PROTECTION GAP: CURRENT AND NEEDED REMEDIES

Mr. Chairman and Members of the Subcommittee, there can be no doubt that the existing statutory framework is woefully outdated and not up to the demands of a rapidly changing marketplace. As you may know, NASAA, AARP and the Consumer Federation of America (CFA) have developed the following minimum standards for evaluating Congressional reform legislation in this area:

- ***Mandatory use of disclosure that is proven to work.*** It is clear that what is being done now in terms of disclosure is not working. Disclosure about the risks of uninsured bank products should be in the form of a concise and "simple English" document and related lobby posters. No sale of an uninsured product should be permitted to take place before the disclosure document is provided and the consumer signs a statement indicating an understanding that mutual funds, stocks and annuities sold at banks are not FDIC insured. In view of the apparent ineffectiveness of current disclosures, AARP, CFA and NASAA are prepared to assist in the development and testing of model disclosure documents and other materials that can be proven to be effective in eliminating the current consumer confusion about the extent of FDIC and SIPC insurance coverage.

- ***A ban on naming or advertising uninsured bank products in any way that creates confusion with insured bank products or the institution itself.*** Many consumers mistakenly believe that uninsured bank products are FDIC insured in the same manner as traditional bank products. As a result, every precaution must be taken to avoid undue confusion in the consumer's mind about the "dividing line" between uninsured products on the one hand and the safety and soundness of the bank and its traditional insured products on the other. The use of the same or similar names and logos of banks and their affiliates or subsidiaries should be prohibited. Additionally, some mutual funds and other uninsured investment products sold at banks should be renamed in order to bring an end to existing instances of the blurring of the line between uninsured and insured bank products.

- ***No "gap" in the consumer protection available to bank customers buying investment products.*** Consumers who invest in mutual funds and stocks through brokerage firms or investment companies are provided a comprehensive framework of consumer protections, including suitability requirements, fair dealing and disclosure of risks and costs. Though much of the activity in investments sold through banks is conducted by

subsidiaries registered as broker-dealers, there is the potential for banks to deal directly with individuals and firms who would not be subject to broker-dealer regulation. This disturbing possibility has already become reality in some instances. At the same time, a serious effort must be undertaken to review the extent and effectiveness of current state and federal regulatory oversight. All investors in mutual funds, stocks and annuities should be accorded the same level of consumer protection.

- ***A mandatory physical separation of the sale of insured and uninsured products within banks.*** The commingling of insured and uninsured activities in bank lobbies greatly increases the potential for consumer confusion. Because of this, no bank should be able to sell insured and uninsured products from the same desk, window or lobby area. A clear, physical separation should exist (along with appropriate lobby posters) in order to distinguish the areas within banks where the two types of products are sold.

H.R. 3306, the DEPOSITORY INSTITUTION RETAIL INVESTMENT SALES and DISCLOSURE ACT

Mr. Chairman and Members of the Subcommittee, NASAA commends you for focusing attention on the very serious consumer protection concerns that arise in connection with the sale of uninsured investment products on bank premises. The reform measures contained in H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act,[18] are a recognition that more must be done to protect consumers from misleading and deceptive sales practices. Key provisions of H.R. 3306 are appropriately targeted to the following areas of potential abuse: (1) disclosure of investment risk and the uninsured nature of non-deposit investment products; (2) sales practices; (3) advertising; (4) physical segregation of insured and uninsured activities; (5) qualifications and compensation of securities sales personnel; (6) common names and logos for insured and uninsured activities; and (6) the use of confidential customer information.

H.R. 3306 represents an important step forward in the debate concerning reform of the current practices involved in the sale of uninsured investment products on bank premises. By identifying those practices most likely to have the effect of blurring the distinction between traditional banking activities and the broader range of uninsured activities now taking place in many bank lobbies, the sponsors of H.R. 3306 have laid the foundation for what could be an extraordinary piece of pro-consumer, pro-competition financial reform legislation. That will be accomplished, however, only if certain substantive

---

[18] H.R. 3306 was introduced on October 20, 1993, by Chairman Henry Gonzalez and Representative Charles Schumer.

changes are made to the bill and if it is joined with H.R. 3447, the Securities Regulatory Equality Act.[19]

What is most troubling to NASAA about H.R. 3306 is its apparent rejection of the concept of functional regulation. Rather than rely on the laws, rules and regulations that have grown up over a 70-year period to protect investors, the authors of H.R. 3306 instead would seek to have federal banking regulators attempt to incorporate into their oversight functions the sale of investment products. H.R. 3306 does not succeed, however, in creating a regulatory scheme comparable to that under the federal securities laws. Further, NASAA questions whether the banking regulatory agencies have the resources to police the marketplace adequately. On the securities side, you have not only the federal Securities and Exchange Commission, you also have 51 state securities agencies and multiple self-regulatory organizations, including the NASD and the New York Stock Exchange. All of these entities work together to ensure the integrity of the marketplace. Rather than relying on this experienced and extensive network of securities regulators, H.R. 3306 essentially would ask federal banking regulators -- who have had no prior experience in investor protection, in writing rules or enforcing compliance in the securities arena -- to take on the job of protecting investors who purchase uninsured investment products on bank premises.

Mr. Chairman and Members of the Subcommittee, the current mismatched regulatory system defies common sense and should not be allowed to continue. As such, NASAA would strenuously object to codifying the system, as would be the case under H.R. 3306. Banking regulations and examinations are generally aimed ensuring bank safety and soundness and depositor protection. As a result, banking regulators view maintaining the stability and profitability of the institution as their first priority. In contrast, protecting individual investors is the overarching mission of securities law and the enforcement efforts taken by securities regulators reflect as much. There simply is no way to attempt to overlay on to the banking laws and regulatory system the mission and purpose of securities laws. It does not work.

As stated earlier, NASAA's primary objection to H.R. 3306 is its rejection of the concept of functional regulation. Why is NASAA opposed to a system that relies on bank regulators and banking laws to ensure that investors are protected from fraud and abuse? Consider the following:

- ***Securities laws provide for a private right of action***. Securities laws provide for -- and rely on -- private enforcement actions to supplement government actions. No such system of redress exists in banking laws, nor does H.R. 3306 provide for it. The fundamental purpose of federal

---

[19] H.R. 3447 was introduced on November 4, 1993, by Representatives Dingell, Markey, Moorhead and Fields and was referred to the Committee on Energy and Commerce.

securities laws is to ensure full disclosure to investors and to punish those who violate the law. Private actions have become increasingly important as an enforcement tool in light of the dramatic growth of fraud and corruption in the nation's business community and financial institutions and the limitations on state and federal prosecutorial and regulatory resources. In short, private actions under the federal securities laws are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace. An absence of private actions may well have the effect of eroding confidence in the capital markets, thereby reducing investment and increasing the cost of raising capital for U.S. businesses.

o ***There is a comprehensive scheme under the securities laws for licensing brokers, including training, testing and tracking.*** Although H.R. 3306 requires that salespersons in banks "meet qualification and training requirements that the Federal banking agencies jointly determine are equivalent to the training and qualification requirements applicable to a person who is registered with the Commission as a broker or dealer, or as an investment adviser," NASAA questions how this will be accomplished. Will federal banking regulators put in place a similar licensing scheme for bank personnel selling investment products? Will the federal banking regulators be in a position to develop and administer examinations to test the knowledge and competence of applicants seeking to become securities salespersons? Will banking regulators be in a position to monitor the activities of such individuals and take action when appropriate? An extensive and rigorous program for training and testing of applicants is well established in the securities regulatory system. Securities regulators also track the disciplinary history of brokers in an effort to screen out bad actors. In addition, the brokerage firms and self-regulatory organizations now are moving to put in place continuing education programs to ensure that those in the securities business keep current with new products and trading strategies, as well as new laws and regulatory requirements.

o ***Securities salespersons are subject to rules of fair practice.*** The rules of the securities industry's self-regulatory organizations and state securities laws and regulations require brokers to comply with rules of fair practice. These rules are designed to ensure that brokers observe high standards of commercial honor and just and equitable principles of fair trade in the conduct of their business. Violation of the rules may result in a fine, suspension or revocation of a securities license. Among the issues covered by the rules of fair practice are: making unsuitable recommendations not in accordance with a client's financial condition, sophistication or risk tolerance; "churning" accounts over and over for commissions;

unauthorized trading; misrepresentations as to the possible risks or true nature of the investment product; fraudulently inducing a client to purchase an investment product; and providing advice unfounded in fact.

- ***Securities regulators routinely make available to the public information about the background and disciplinary history of stockbrokers.*** The licensing of stockbrokers is accomplished through a sophisticated computer network -- the Central Registration Depository (CRD) -- jointly operated by NASAA and the NASD. Today, the system contains registration and disciplinary files on 5,200 brokerage firms and more than 440,000 individual stockbrokers. The system captures substantial disciplinary history about registrants and draws from several sources for its data. Individual registrants and their employing brokerage firms also are required to disclose fully all disciplinary history; a failure to do so may serve as a separate ground for state licensing actions. The CRD database now serves as a primary source of information for investors to learn about the disciplinary and employment history of stockbrokers. Today, investors may call either their state securities agency or the NASD to access background data on a particular stockbroker or firm. NASAA and the individual states use every opportunity available to them, including the news media, speaking engagements, public statements, and more, to alert consumers to this service. There are no comparable licensing requirements for bank personnel, nor are we aware of any efforts contemplated by federal banking regulators to design, build or maintain such a computer system for those bank personnel who may now sell securities or render investment advice.

- ***Securities regulators employ a high-profile program for exposing securities law violators, thereby warning the public about a troublesome scheme, firm or individual.*** Federal and state securities regulators, as well as the industry's self-regulatory organizations, deliberately seek to publicize as widely as possible any disciplinary action taken against individual brokers or brokerage firms. The goal is to provide as much information as is possible to the investing public so that they may avoid dealing with unscrupulous or dishonest operators.

Mr. Chairman and Members of the Subcommittee, it is obvious that such an elaborate and highly specialized oversight function as currently exists for securities brokers and firms simply cannot be duplicated by federal banking agencies, unless there are thousands of employees now sitting in these agencies with nothing to do and millions of dollars of taxpayer money available to be spent on putting in place a duplicative infrastructure necessary to carry out such a program. In addition, such efforts would seem to run contrary to the Administration's stated goal of regulatory consolidation.

NASAA would suggest that a more reasonable and appropriate approach would be for Congress to incorporate into the functional regulation system envisioned in H.R. 3447 the major concepts embodied in H.R. 3306. The continued exclusion of banks from the definitions of "broker" and "dealer" serves no public interest, and to the contrary, means that banks need not comply with the customer protection, net capital, and books and records rules specifically designed to protect investors. The result would be strengthened investor protection, without duplicative and costly overlap in the functions of federal securities and banking regulators. NASAA would suggest that the following provisions of H.R. 3306 (with certain modifications) be added to the functional regulation bill:

- ***A prohibition on banks sharing confidential customer information with any affiliated securities operations.*** Most bank customers would be extremely disturbed to learn that financial institutions routinely are sharing with securities salespersons what commonly is considered confidential information about the customer's finances, including the maturity dates of these CDs. It is clear that banks are supplying this information to brokerage operations in the hopes of persuading bank customers to purchase uninsured investment products with the funds earned when CDs have been cashed in. NASAA applauds your efforts in this area and intends to examine this issue as it relates to the sharing of consumer financial information in the investment marketplace.

- ***Physical segregation of securities sales activities.*** In testimony on March 2, 1994, before the House Energy and Commerce Subcommittee on Oversight and Investigations, federal prosecutors in the Lincoln Savings case claimed that the sale of American Continental Corporation (ACC) bonds in the Lincoln lobbies dropped off sharply after the bank was forced to move the sale of the uninsured investment products out of the bank lobbies. It is clear that one reason consumers are so confused about the uninsured status of investment products sold in bank lobbies is due to the blurring of the distinction between the traditional (and insured) banking activities and the investment-related (and uninsured) activities. There should be a clear segregation of insured and uninsured products. Having said this, NASAA also recognizes that small banks may have great difficulty in achieving the physical and personnel separation that NASAA believes is essential. As such, NASAA is willing to work with Congress and representatives of smaller, community banks to design a modification of this requirement to accommodate such institutions. NASAA believes that such modifications may be accomplished without opening up a broad loophole.

- ***A prohibition on similar or common names or logos.*** NASAA supports an explicit ban on the use of similar, common or identical names and logos when banks sell uninsured investment products. Again, this is an area in

which there is strong potential for consumer confusion and should be prohibited. NASAA would suggest, however, that the authority granted to federal banking regulators to waive this prohibition should be deleted in favor of a strict and universally applied ban.

- ***Improved disclosure about the uninsured nature of investment products and the risks and fees associated with them.*** It is clear that whatever banks are currently providing in terms of disclosure simply is not working. Customers remain confused about the uninsured status of investment products and the risks and fees associated with them. As a result, NASAA supports improved disclosure. An additional area in which there is a desperate need for clear and accurate disclosure is that concerning SIPC coverage. Whether intentional or not, the discussion of SIPC coverage in connection with investments sold at banks, as state securities regulators have seen it in many instances, is clearly misleading. In fact, when SIPC is mentioned, it appears to be designed to give false comfort that it is somehow analogous with FDIC insurance, which is most certainly not the case. In addition, NASAA recommends that the disclosure be required for all transactions, solicited as well as unsolicited. The timing of the disclosure also should be more clearly spelled out to reflect how it is that securities transactions actually take place. Finally, it is NASAA's view that federal regulators should join with us in using focus groups and other means to test its clarity and usefulness to consumers.

STATE EFFORTS

It also is recognized that a serious effort must be undertaken to review the extent and effectiveness of current state securities regulatory oversight. The first order of business for state securities regulators has been to gather information about what is going on in the marketplace and to get a better sense of how it is that banks are entering the securities business. A NASAA committee on which I serve as vice chair, the Banks Securities Committee, was established last September and has been charged with reviewing state securities laws and regulations to determine what changes may be necessary in view of the expanding role that banks are playing in the securities marketplace. In addition, NASAA is taking a hard look at the current statutory authority of state securities regulators to determine what changes may be necessary in the oversight of registered broker-dealers who operate on bank premises. Finally, a number of individual states also are moving to put in place new rules governing the bank activities of broker-dealers.

CONCLUSION

Mr. Chairman and Members of the Subcommittee, it is abundantly clear that more and more consumers are turning to their banks for the purchase of uninsured investment products. What also is evident is that many of these consumers are very much in the dark about the uninsured nature of the investment products and the risks and fees associated with them. Given what state securities regulators have turned up in their informal look at the promotional, marketing and sales practices in bank lobbies, it is not at all surprising to me that consumers are confused. How could they not be in the face of such a soothing and misleading barrage of advertisements and bank lobby sales pitches?

It is NASAA's view that the time has come for federal legislation to address comprehensively the interrelated issues of securities activities conducted on bank premises and appropriate safeguards to protect investors. We know that banks already are in the securities business in a major way. Recent events serve to underscore and to bring into focus the concerns expressed by NASAA and its members about the steadily increasing role of banks in the securities markets and the lack of legally-mandated investor safeguards.

H.R. 3306 represents an important step forward in the debate concerning reform of the current practices involved in the sale of uninsured investment products on bank premises. By identifying those practices most likely to have the effect of blurring the distinction between traditional banking activities and the broader range of uninsured activities now taking place in many bank lobbies, the sponsors of H.R. 3306 have laid the foundation for what could be an extraordinary piece of pro-consumer, pro-competition financial reform legislation. That will be accomplished, however, only if certain substantive changes are made to the bill and if it is joined with H.R. 3447, the Securities Regulatory Equality Act, which would provide for functional regulation of securities activities.

Bringing lifetimes of experience and leadership to serve all generations.

STATEMENT OF

TESS CANJA
MEMBER, BOARD OF DIRECTORS
OF THE
AMERICAN ASSOCIATION OF RETIRED PERSONS

ON

BANK SALES OF UNINSURED PRODUCTS

BEFORE THE

HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE
FINANCIAL INSTITUTIONS SUPERVISION, REGULATION
AND DEPOSIT INSURANCE SUBCOMMITTEE

MARCH 8, 1994

For further information, contact:
Kent Brunette
(202) 434-3800

American Association of Retired Persons 601 E Street, N.W. Washington, D.C. 20049 (202) 434-2277
Lovola W. Burgess *President* Horace B. Deets *Executive Director*

Hello, my name is Tess Canja. I'm a member of the Board of Directors of the American Association of Retired Persons from Port Charlotte, Florida. I'm pleased to be here today to present AARP's views on bank sales of uninsured products.

Gone are the days when every product encountered in a bank lobby was federally insured. All sorts of uninsured products are now being sold at banks, including annuities, mutual funds, life insurance, and brokerage services. While the range of products offered by banks has been increasing, so has something else: consumer confusion! Indeed, today's financial services marketplace is more complex and confusing than ever before.

Older people are among the most vulnerable groups in this environment. Many older investors have seen the income from their insured savings accounts and certificates of deposit drastically lowered by plummeting interest rates. This substantial loss of income has driven many older people into much riskier investments. Some older people have made these investments without fully understanding the risks involved.

AARP, along with the North American Securities Administrators Association (NASAA), recently released the results of a national survey which graphically demonstrated the degree to which consumer confusion reigns. A whopping 82% of survey respondents were unaware of the deposit insurance status of mutual funds sold by banks. 86% were unaware of the deposit insurance status of bank-sold annuities. Diane Colasanto, from Princeton Survey Research Associates who conducted the AARP/NASAA survey, is here to discuss the survey findings a little later.

Mutual funds, annuities, and other products may represent attractive investment opportunities which promise greater returns than insured deposit accounts. AARP certainly does not want to discourage older investors from considering these products. But, investors

must be fully informed about the products they are purchasing and the risks they are assuming. They must enter into these transactions with their eyes wide open.

Part of the responsibility for deciphering today's marketplace obviously rests with the consumer. Consumers need to learn more about the various products they encounter. They need to be able to sort through the bewildering array of products and select those best suited to their needs. Before this can occur, however, steps must be taken to assist consumers in finding their way through today's financial services marketplace.

Consumers today are being subjected to aggressive marketing campaigns touting the virtues of uninsured products and their ready availability at local bank branches. These advertising and promotional campaigns sometimes blur the distinctions between what's insured and what's not. As a result, current banking practices are contributing to marketplace confusion.

Banks selling uninsured products tend to fall into one of three categories:

- **Banks that are rushing to the bottom**

  A large number of banks are not complying with existing federal banking guidelines. Questionable practices include: using identical logos for insured and uninsured products, using names similar to the bank's to identify bank-offered mutual funds, not disclosing the deposit insurance status on some uninsured products, and commingling lobby advertising and promotional literature for insured and uninsured products.

- **Banks that are providing perfunctory, legalese disclosures**

  Many of the banks in the country are providing perfunctory, legalese disclosures. These are usually provided in very small, light print that often requires a magnifying glass to decipher, are buried as footnotes that require some hunting to find, or appear in lobby advertisements that require a customer to stoop down in order to read.

- **Banks that are rising to the occasion by going beyond minimal requirements**

  A handful of banks provide highly visible disclosures in lobby displays, brochures, forms, and advertising that are designed to make the distinctions between insured and uninsured products abundantly clear to consumers.

When more than four out of five customers are unaware that investments sold through banks are *not* insured, it is time for the federal government to step in to bring some sense to today's marketplace. Guidelines by federal banking regulators and voluntary endeavors by banking industry trade associations represent nothing more than quick fixes which do not resolve underlying problems. Marketplace abuses need to be prohibited; better disclosures are required; stronger enforcement actions must occur. Enactment of mandatory federal standards is needed to accomplish these consumer protection goals. The following actions are needed:

- **Congress must pass strong consumer protection legislation**

  Congress has provided Americans with consumer protections

correcting marketplace abuses relating to home equity loans, credit cards, investment advisors, penny stocks, check holds, account disclosures, and a variety of other problems. Strong, congressionally mandated protections are needed for consumers who might unwittingly place their life savings in jeopardy by investing in uninsured products at their banks. AARP, NASAA, and the Consumer Federation of America (CFA) are developing a legislative proposal which incorporates many of the concerns identified by banking regulators and trade groups into a comprehensive consumer protection measure. Passage of such legislation is needed before a market correction causes unexpected losses for investors who were lulled into a sense of security in purchasing uninsured products at their bank.

- **Banking regulators must proceed with extreme caution**

  Until the above statutory protections are in place, AARP urges the federal banking regulators to proceed with extreme caution before approving any new banking activities which could exacerbate consumer confusion. If such approvals are to occur, up-front consumer protection commitments are needed.

- **Banking regulators must improve enforcement**

  The federal banking regulators are to be commended for identifying and taking some initial steps to address consumer

protection issues relating to bank sales of uninsured products. The Comptroller of the Currency has developed a very good brochure which clarifies the differences between investments and deposits. Much more, however, needs to be done to adequately protect consumers. The banking regulators need to implement the following enforcement strategies for identifying and correcting marketplace abuses:

Send Testers Into Bank Lobbies

To more accurately gauge conditions in the marketplace, anonymous testers need to be sent into bank lobbies to gather information on bank sales practices, product promotions, oral representations, written disclosures, and other related activities.

Develop A System For Capturing Consumer Complaints

Most consumers do not know where to complain if they have problems with uninsured products sold by banks. If they want to notify the bank's regulator, most people don't know whether to complain to the state banking commissioner, Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, or the Office of Thrift Supervision. If a complaint relates to the sale of a securities product, it might need to be sent to the Securities and Exchange Commission or the state securities regulator. If it relates to the sale of an insurance

product, the state insurance commissioner probably needs to be informed. To assure that all complaints are being captured, a uniform consumer complaint form needs to be developed, made publicly available in bank lobbies, and distributed to all purchasers of uninsured bank products. A system needs to be set up under which complaints lodged with one regulator are shared with other appropriate regulators.

Hold Public Field Hearings

The federal banking regulators conducted a series of field hearings when recently contemplating actions relating to the Community Reinvestment Act. Similar field hearings need to be held around the country to solicit public opinion relating to bank sales of uninsured products. Such forums would generate significant media attention in the cities where they are held and would help educate the public on the differences between insured and uninsured products.

AARP appreciates this opportunity to comment. We look forward to working with the subcommittee towards achieving the goals identified above.

Bank Investment Products Survey
January 1994

Conducted for:

The American Association of Retired Persons
The North American Securities Administrators Association

Conducted by:

PRINCETON SURVEY RESEARCH ASSOCIATES

Princeton Survey Research Associates
P.O. Box 1450
Princeton, NJ 08542

(609) 924-9204

Consumers may not have caught up with all of the changes in the financial marketplace. While banks have diversified their activities and now offer an array of financial products like mutual funds and stocks, many consumers still cling to older notions about the safety of bank accounts. In this new climate, many Americans have falsely concluded that the FDIC offers the same protection to mutual funds, stocks, and annuities offered by banks that it offers to savings and checking accounts. Only a minority of commercial bank customers understand that products like mutual funds, stocks, annuities, and government bonds that are sold at banks are not FDIC-insured.

These are some of the findings from a recent study by Princeton Survey Research Associates, which explores what financial decision-makers who use commercial banks understand about FDIC insurance, and uninsured products like mutual funds and annuities sold by banks. Major findings include:

- While most commercial bank customers say that they understand costs and rules associated with their bank accounts, fewer say they understand the financial risks associated with these accounts.

- Fewer than one in five commercial bank customers (whose banks offer these products) understands that government bonds, mutual funds, or annuities are uninsured. Three-quarters (75%) of commercial bank customers whose bank sells stocks do not realize these are uninsured.

- There is a gender gap on knowledge of financial risk: Men are twice as likely as women to know that stocks, mutual funds, and annuities are not FDIC-insured.

- Customers who have bought mutual fund or annuities at their bank are not better informed about FDIC insurance, and are even somewhat more likely to think that mutual funds and annuities are insured.

- Over a third (36%) of consumers who bought a mutual fund had not spoken with anyone at their bank about the appropriateness of this kind of investment.

- Many consumers who bought mutual funds through a commercial bank are unaware of the costs and fees that banks charge them. Only 36% of mutual fund owners say they are paying front-end sales loads, although most bank mutual funds charge this fee.

- Americans continue to trust their banks: 88% say they have always received good information about the risk of bank investments from their bank.

- Banks seem to market uninsured investment products more aggressively to older Americans. Almost half of bank customers age 65 and older, but just a third of younger customers, have been contacted by their banks about investing in mutual funds.

These are some of the findings from a study of 1,000 financial decision makers who presently have a relationship with a commercial bank. Princeton Survey Research Associates conducted a telephone survey study from October 14 to October 31, 1993 on behalf of the American Association of Retired Persons and the North American Securities Administrators Association in order to investigate Americans' current level of understanding about banking products and FDIC insurance.

TODAY'S FINANCIAL MARKETPLACE

Today's financial decision-makers have relationships with several different institutions apart from their commercial bank. Almost half (48%) report using a savings bank, over a third report using a savings and loan company (35%), and 38% report using a credit union. One in four commercial banking customers also uses a mutual fund company and one in five (21%) uses a brokerage company. Financial decision-makers therefore must sift through a variety of rules and fee structures in order to handle the demands of the current marketplace.

Relationships With Financial Institutions

(Base = Total Sample of Commercial Bank Customers)

	Percent Who Use For Banking and Investments
Credit Union	38
Brokerage Company	21
Mutual Fund Company	25
Insurance Company	30
Savings & Loan Company	35
Savings Bank	48
Commercial Bank	100
	(n=1,000)

Consumers may not have caught up with all of the complexities in this diversified environment. While almost all respondents know their bank offers checking, savings and

certificates of deposit, considerable numbers remain confused as to whether their bank offers financial products like stocks and bonds. Over a third (35%) do not know if their bank sells mutual funds or stocks, and 42% do not know if their bank sells annuities. Twenty-eight percent cannot say whether their bank sells government bonds.

Awareness of Banking Products

(Base= Total Sample of 1,000 Commercial Bank Customers)

Does your bank offer...?

	Yes %	No %	Don't Know %
Checking Accounts	100	*	*
Savings Accounts	99	1	*
Certificates of Deposit	92	3	5
Money Market Accounts	80	6	14
Government Bonds	63	9	28
Mutual Fund Accounts	49	16	35
Annuities	44	14	42
Stocks	30	35	35

*less than 0.5%

Whatever else has changed, Americans still place a special trust in their banks. This confidence expresses itself in several ways. A strong majority (88%) feel their banks have

given them good information about their investments; only 4% feel they have been misled or misinformed. Given their faith in banks, most (82%) consumers say they would contact their own bank if they experienced a problem with any of their accounts or investments, rather than contacting other sources. Very few consumers say that they would contact a government agency in this situation.

Some of this trust is also reflected in consumer attitudes about banking costs and regulations. Most (82%) report it is easy to understand the different fees and rates that their bank charges. Three quarters think it is easy to understand the rules and regulations applying to different accounts and services.

Even while consumers express trust in banks, they are less comfortable with their own understanding of financial risk. Fewer consumers (57%) say it is easy to understand the financial risks involved in making different kinds of investments through their bank. Older consumers are even more uneasy about this issue: only half of the consumers over 65 years of age report this vs. 59% for younger bank customers.

Do you think it is easy or hard to understand . . . ?

(Base = Total Sample of 1,000 Commercial Bank Customers)

	Easy %	Hard %	Don't Know %
Financial risks involved in making different kinds of investments through your bank	57	25	18
The rules and regulations that apply to different accounts and services your bank offers	75	21	4
The different fees and rates your bank charges for their services	82	16	2

DO AMERICANS UNDERSTAND THE FDIC?

The Federal Deposit Insurance Corporation protects the value of bank deposit accounts up to $100,000. The FDIC insures certificates of deposits, and savings and checking account deposits. On the other hand, financial instruments based upon debt or equity are not insured by the government.

Most financial decision makers (92%) are aware of the FDIC, and this awareness is linked to income, education, and gender. Almost all (97%) of the college graduates have heard of the FDIC, while only 71% of those without a high school diploma have heard of it. Men and higher-income respondents are also more likely to have heard of the FDIC.

Before today had you heard of the FDIC?

(Base = Total Sample of Commercial Bank Customers)

	Yes %	No %	N
Total	92	8	(1,000)
Household Income			
Less than $20,000	86	14	(172)
$20,000-$39,999	93	6	(313)
$40,000-$59,999	97	3	(187)
$60,000 and over	98	2	(191)
Education			
No high school	71	29	(64)
No college	89	10	(665)
College	97	3	(328)

As we have seen, most consumers express faith in banks and appear confident about their understanding of the rules and regulations governing their accounts. However, consumers are confused about FDIC insurance. Many believe the FDIC program offers much broader protection to bank products than it actually does -- protection extending to bonds, mutual funds, and stocks. This suggests that many bank investors may have a false confidence in the security of their bank investments.

If we consider our survey questions as a kind of financial awareness test, then most financial decision-makers have failed it. We asked only those respondents whose bank offered a specific product (e.g., market accounts) if the FDIC insured that

product. In other words, this was not an abstract question -- but a real measure of how well customers understand products offered by their own commercial bank. We should stress that this was a conservative analysis since consumers who are unaware of what their bank offers (and therefore are even less knowledgeable) were not tested on their understanding of whether FDIC insurance applies to these particular bank products.

The answers reflect a surprising ignorance about financial risk: most respondents either do not know or give the wrong answer about FDIC protection of uninsured products -- far outnumbering the "correct" responses:

> Only 14% of those whose banks sell government bonds realize that these are uninsured, while 47% incorrectly report that bonds are FDIC-insured, and another 39% do not know.

> Considering respondents whose banks sell mutual funds, only 18% know that these are not FDIC-insured. Thirty-nine percent incorrectly report mutual funds offered by banks as FDIC-insured, and another 43% do not know whether mutual funds from their banks are insured.

Does FDIC insure product?

(Base = Own Bank Offers Product)

	Yes %	No %	Don't Know %	N
Checking Accounts	79	5	16	(993)
Savings Accounts	86	1	13	(989)
Certificates of Deposit	71	3	26	(921)
Money Market Accounts	56	10	34	(814)
Government Bonds	47	14	39	(636)
Mutual Fund Accounts	39	18	43	(496)
Annuities	40	14	46	(445)
Stocks	35	25	40	(305)

It is reasonable to think that people who actually bought mutual funds from their bank would be better informed -- because they have real experience with the product. On the contrary, those who bought mutual funds from their commercial bank are somewhat more likely to give the wrong answer: 52% say their mutual funds are FDIC-insured. Only 17% of mutual fund owners realize their accounts are not FDIC-insured.

The situation is similar for annuities: those who have bought annuities from a bank are no better informed than other people (and in fact are slightly less informed). Among owners of

annuities, 55% claim incorrectly that these are FDIC-insured, and only 17% realize their accounts are uninsured. By comparison, 40% of all respondents whose banks sell annuities say annuities are insured.

One group that might be expected to be especially well-informed are consumers who have direct relationships with brokerage and mutual fund companies, and therefore, might be more experienced investors. Indeed, these consumers do know more about FDIC insurance -- and are about three times as likely to give the correct answer about FDIC coverage of mutual funds, stocks and annuities. However, while the differences are striking, even these investors are hardly savvy -- the majority still fail to understand that the FDIC program does not cover these bank investments.

Experience With Brokerage and Mutual Fund Companies

(Base = Own Bank Offers Product)

Does the FDIC insure...	Use Brokerage/ Mutual Fund Company	Don't Use Brokerage/ Mutual Fund Company
Government Bonds (n=636)		
Yes	44	48
No	22	10
Don't know	34	42
Mutual Fund Accounts (n=496)		
Yes	35	41
No	33	11
Don't know	32	48
Annuities (n=445)		
Yes	32	44
No	26	8
Don't know	42	48
Stocks (n=305)		
Yes	20	43
No	48	13
Don't know	32	44

The same is true for consumers with higher education and higher income: they are more knowledgeable than other consumers, but still are largely misinformed. For example, college graduates are twice as likely as those with lower educational attainment to say annuities are uninsured. Twenty-two percent of college graduates report this, while only 11% of others report this. Still, the fact remains that most college graduates and higher income respondents fail to correctly understand how the FDIC program operates. Low-income Americans (under $20,000 in household income) know the least about FDIC insurance. Fewer than one in ten low-income Americans understand that products like mutual funds and stocks are not FDIC-insured.

Does FDIC Insure Product by Income and Education?

(Base = Own Bank Offers Product)

Percent Who Know Each Product is Not FDIC-insured

	Gov't Bonds %	Mutual Funds %	Annuities %	Stocks %
Household Income				
Less than $20,000	7	7	4	7
$20,000-$39,999	11	14	14	18
$40,000-$59,999	13	21	12	33
$60,000 and over	28	33	25	49
Education				
Not a college graduate	11	14	10	19
College graduate	22	27	21	41

There is also a gender gap on this issue. Men are more than twice as likely to know the limitations of the FDIC program. For example, 29% of men know that bank mutual funds are not FDIC-insured, compared to only 10% of women. Thirty-nine percent of men know stocks purchased at a bank are uninsured, while only 15% of women know this. A mere 5% of widowed or divorced women realize that stocks offered by their banks are uninsured.

Effect of Gender on Knowledge of Uninsured Financial Products

(Base = Own Bank Offers Product)

Percent Who Know Each Product is Not FDIC-insured

	Men %	Women %
Government Bonds	20	9
Mutual Fund Accounts	29	10
Annuities	20	9
Stocks	39	15

Most financial decision makers are well informed about bank investment products that are insured. Among respondents whose banks offer these products, most know checking accounts (79%) savings accounts (86%) and certificates of deposit (71%) are insured. Money market accounts are more confusing to people: a third (34%) do not know whether they are FDIC-insured.

MUTUAL FUNDS AND ANNUITIES

Banks have made inroads in selling their customers a variety of financial products. The majority of commercial bank customers report having either a checking account (95%) or a savings account (82%) at their commercial bank; 43% say that they have a certificate of deposit. A quarter report having a money market fund, and almost as many (23%) report purchasing a government bond through their bank. Few respondents have invested in mutual funds (6%), stocks (5%), or annuities (3%) at their commercial bank. Among those reporting that their bank sells these products, 12% have bought mutual funds, and 8% have bought annuities.

Financial Products Purchased at Commercial Banks

(Base = Total Sample of Commercial Bank Customers)

Have you personally purchased...?

	%
Checking Accounts	95
Savings Accounts	82
Certificates of Deposit	43
Money Market Accounts	25
Government Bonds	23
Mutual Funds	6
Annuities	3
Stocks	5
Number of Interviews	(1,000)

Income is not the determining factor in who buys uninsured financial products from a bank. Poorer consumers (household income under $20,000) are just about as likely to invest in higher-risk bank products like stocks, annuities and mutual funds as consumers with more income. As we have seen, very few of these poorer consumers understand that their investment is not protected by the FDIC.

Financial Products Purchased at Commercial Banks

(Base = Total Sample of Commercial Bank Customers)

	Household Income			
	Less than $20,000 %	$20,000-$39,999 %	$40,000-$59,999 %	$60,000 or More %
Checking Account	96	97	95	97
Savings Accounts	77	86	86	85
Certificate of Deposit	38	35	42	56
Money Market Account	17	22	25	33
Government Bonds	25	24	20	24
Mutual Funds	5	6	4	7
Annuities	3	2	4	6
Stocks	4	3	5	7
Number of Interviews	(172)	(313)	(187)	(191)

Older (over 65 years) consumers are more likely than younger consumers to report buying government bonds, money market accounts, certificates of deposit, and stocks from their commercial bank.

Financial Products Purchased at Commercial Banks

(Base = Total Sample of Commercial Bank Customers)

	Age	
	18 to 64	65 and older
Government Bonds	21	31
Money Market Account	22	37
Mutual Funds	6	5
Checking Account	95	97
Certificate of Deposit	40	57
Annuities	4	3
Stocks	4	10
Savings Accounts	83	79
Number of Interviews	(842)	(140)

Most consumers decide to buy mutual funds or annuities from banks either on their own or through a personal financial advisor. However, some are brought into the market directly by their bank, either through a bank officer, a bank teller, or some other bank employee.

Of those who are aware that their bank sells mutual funds, over a third (34%) say they were contacted by their bank about investing in the bank's mutual fund. Most (80%) of this contact is by mail, although 15% of respondents were solicited by telephone and another 5% by personal visits. People age 65 and older are contacted by their banks about buying mutual funds more often than younger people. About half of older bank customers (47%), but just a third of younger customers (32%) say their bank contacted them about mutual funds.

Mutual funds can be a risky investment, and are not appropriate for everyone. However, not all investors are obtaining advice from their banks. While over half (57%) of mutual fund owners had talked with someone at their bank about the appropriateness of investing in mutual funds, more than a third (37%) say that no one had spoken with them. Another 7% could not remember.

Can you remember who initially advised you to invest in a mutual fund/annuity at your bank?

(Base = Bank Mutual Fund & Annuity Owners)

	Mutual Fund Owners	Annuity Owners
	%	%
Own decision	41	49
Financial advisor	14	21
Bank officer	15	10
Bank teller	2	3
Other bank employee	6	3
Other	6	3
Number of Interviews	(60)	(34)

Has your bank ever contacted you to ask if you wanted information about mutual funds or to see if you wanted to purchase a mutual fund?

(Base = Own Bank Offers Mutual Funds)

	Total	Mutual Fund Owners
	%	%
Yes	34	39
No	62	56
Don't know	4	5
Number of Interviews	(488)	(60)

How were you contacted?

Telephone	15	20
Personal visit	5	0
Mail	80	72
Other	10	22

Bank Guidance in Mutual Fund & Annuity Investments

(Base = Have Purchased Mutual Funds or Annuities at Own Bank)

	Mutual Fund Owners %	Annuity Owners %
Before you invested, did someone at your bank talk with you about your investment and its appropriateness for you?		
Yes	57	57
No	36	38
Don't know	7	5
Did your bank give you any written disclosure or any information describing the risks of this kind of investment?		
Yes	85	63
No	10	25
Don't know	5	12
	(60)	(34)

Most banks provide written disclosures about mutual funds and annuities to their customers. Eighty-five percent of mutual fund owners say their bank had given them a written statement, and 63% of annuity owners say the same. More than three quarters of consumers read these materials although, as we have seen, their understanding of these disclosures was limited.

Banks charge customers for these accounts in a variety of ways -- but many customers are unaware of the fees their banks charge. The picture that emerges is that customers who go to banks for mutual fund and annuity purchases are not competitive shoppers. For example, while many mutual fund companies offer "no-load" funds, most banks charge a front end sales load. Only 36% of bank mutual fund owners are aware of this. A third of these owners say that they do not know about this, but the rest think that they have avoided these sales loads. Almost half report that they are being charged redemption fees (46%), while 29% do not know. And, 38% report that they pay asset management fees, while 26% do not know.

Annuity owners are similarly confused about their fees. About a third do not know if they are charged a sales load (36%) or insurance expense (32%), and 43% do not know if they are charged an asset management fee.

Mutual Fund Charges and Fees

(Base = Have Purchased Mutual Funds or Annuities at Own Bank)

Does your bank charge the following:

	Mutual Fund Owners (n=60)
Front-end sales load	
Yes	36
No	32
Don't know	32
Redemption Fee	
Yes	46
No	25
Don't know	29
Management Fee	
Yes	38
No	36
Don't know	26

	Annuity Owners (n=34)
Front-end sales load	
Yes	32
No	32
Don't know	36
Maintenance Fee	
Yes	34
No	42
Don't know	24
Asset Management Fee	
Yes	14
No	43
Don't know	43
Surrender Fee	
Yes	49
No	25
Don't know	26
Insurance Expense	
Yes	30
No	38
Don't know	32

Given the fact that consumers are often unaware of the cost of their investments, it is not surprising that most bank mutual fund and annuity owners are not disturbed by costs and fees that banks charge. Most of the mutual fund and annuity owners report that bank fees and costs are either about what they expected, or lower than they expected. However, a third (33%) of mutual fund owners say the costs and fees associated with their mutual fund are higher than they expected.

Did the costs and fees for your (mutual fund/annuity) turn out to be about what you expected, higher than expected, or lower than expected?

	About as Expected %	Higher %	Lower %	N
Mutual Fund Owners	47	33	10	(60)
Annuity Owners	60	13	6	(34)

STUDY METHODOLOGY:

This survey was conducted by Princeton Survey Research Associates of Princeton, New Jersey on behalf of the American Association of Retired Persons and the North American Securities Administrators Association. The results are based upon telephone interviews with a representative sample of 1,000 adults living in the continental United States who reported making the financial decisions for their household, and who also reported using a regular commercial bank. Interviews were conducted during the period October 14 to October 31, 1993.

After being combined with the subsample of households whose financial decision-makers did not report using a regular commercial bank, these data were weighted to reflect general U.S. household characteristics. The margin of sampling error for the total sample of 1,000 commercial bank customers is plus or minus 3 percentage points at the 95 percent level of confidence. Question wording and the practical difficulties of conducting surveys can also introduce error or bias into survey results.

APPENDIX

Top-line Questionnaire

Bank Investment Products Survey

Princeton Survey Research Associates for
The American Association of Retired Persons and
The North American Securities Administrators Association

10/14/93

Top-line Questionnaire

N=1,000 financial decision-makers who use a commercial bank

Margin of Sampling Error: ± 3 percentage points

Interviewing Dates: October 14-31, 1993

THERE IS NO Q1

2. First, as I read a list of different kinds of financial institutions, please tell me whether or not you use each type for your own banking and investments.

	Yes %	No %	Don't Know %
a. A credit union	38	62	*
b. A brokerage company	21	78	1
c. A mutual fund company	25	75	*
d. An insurance company that offers investment products	30	68	2
e. A savings and loan company	35	64	1
f. A savings bank (NOTE: These have the word "savings" in their name.)	48	52	*
g. A regular commercial bank (NOTE: These are any other kind of bank not included in the previous categories.)	100	0	0

IF MORE THAN ONE YES TO Q2: For these next questions I'd like you to think about the regular commercial bank that you use most often.

THERE IS NO Q3

4. I'd like you to tell me whether it is easy to understand the different kinds of accounts and services available from your bank. For each of the following, please tell me whether you think it is easy or hard to understand. First, . . .

	Easy %	Hard %	Don't Know %
a. the different fees and rates that your bank charges for their services	82	16	2
b. the financial risks involved in making different kinds of investments through your bank	57	25	18
c. the rules and regulations that apply to different accounts and services that your bank offers	75	21	4

5. As far as you know, does your bank offer each of the following products, or not? (DO NOT ROTATE) (NOTE: IF ANOTHER COMPANY SELLS ITS PRODUCTS ON THE BANK'S PREMISES, PLEASE COUNT THIS AS A "YES" BECAUSE THE PRODUCT WAS PURCHASED AT THE BANK.)

		Yes	No	Don't Know
		%	%	%
a.	government bonds	63	9	28
b.	money market accounts	80	6	14
c.	mutual fund accounts	49	16	35
d.	checking accounts	100	*	*
e.	certificates of deposit	92	3	5
f.	annuities	44	14	42
g.	stocks	30	35	35
h.	savings accounts	99	1	*

6. The Federal Deposit Insurance Corporation, or FDIC, is a government agency that guarantees the accounts of people who deposit money in banks. Deposits of up to $100,000 are protected through this program. Before today, had you heard of the FDIC program?

92	Yes have heard of it before
8	No
*	Don't know
100	

7. (ASK FOR EACH "YES" RESPONSE IN Q5) And, as far as you know, does the FDIC insure each of the following savings and investment accounts your bank offers, or not?

	Yes %	No %	Don't Know %
a. government bonds	47	14	39
b. money market accounts	56	10	34
c. mutual fund accounts	39	18	43
d. checking accounts	79	5	16
e. certificates of deposit	71	3	26
f. annuities	40	14	46
g. stocks	35	25	40
h. savings accounts	86	1	13

8. As far as you know, is there any other insurance program that protects the value of (INSERT) at your bank? [Combined Responses for Q.7 and Q.8 based on "yes" to Q. 5]

		Yes, Either FDIC or Other %
a.	government bonds	48
b.	money market accounts	56
c.	mutual fund accounts	40
d.	checking accounts	79
e.	certificates of deposit	71
f.	annuities	41
g.	stocks	36
h.	savings accounts	86

9. And, which of the following accounts and investments, if any, have you personally purchased at your bank? Do not include accounts or investments you purchased at other financial institutions. (DO NOT ROTATE) (NOTE: IF ANOTHER COMPANY SELLS ITS PRODUCTS ON THE BANK'S PREMISES, PLEASE COUNT THIS AS A "YES" BECAUSE THE PRODUCT WAS PURCHASED AT THE BANK.)

	Yes %	No %	Don't Know/ Refused %
a. government bonds	23	77	*
b. money market accounts	25	74	1
c. mutual fund accounts	6	93	1
d. checking accounts	95	4	1
e. certificates of deposit	43	56	1
f. annuities	3	96	1
g. stocks	5	95	*
h. savings accounts	82	17	1

10a. (IF "NO" TO Q9c) As you may know, mutual funds are companies that invest your money in many different stocks and bonds. Has your bank ever contacted you to ask if you wanted information about mutual funds, or to see if you wanted to purchase a mutual fund?

34	Yes
62	No
4	Don't know
100	

10b. (IF "YES" TO Q9c) Before you purchased the mutual fund at your bank, had the bank ever contacted you to ask if you wanted information about mutual funds, or to see if you wanted to purchase a mutual fund?

39	Yes
56	No
5	Don't know
100	

10c. (IF "YES" TO Q10a OR Q10b) And how were you contacted by your bank? Was it by telephone, a personal visit at home, or was it by mail?

15	Telephone
5	Personal visit at home
80	By mail
10	Other (VOLUNTEERED)
1	Don't know
111*	

*Multiple responses

IF NOT "YES" TO Q9c, SKIP TO Q15

10d. (IF OWN A MUTUAL FUND, "YES" TO Q9c) Can you remember who initially advised you to invest in the mutual fund account at your bank? Was it a bank teller, a bank officer, a personal financial advisor, someone else, or is this something you decided to invest in on your own?

2	Bank teller
15	Bank officer
6	Other bank employee (VOLUNTEERED)
14	Financial advisor
6	Other (SPECIFY)
41	Own decision
16	Don't know
100	

11. (IF OWN A MUTUAL FUND) Thinking back to when you first invested in a mutual fund at your bank, did someone at the bank talk with you about your investment goals, your income, and whether a mutual fund is suitable for you?

57	Yes
36	No
7	Don't know
100	

12. (IF OWN A MUTUAL FUND) Did your bank give you any written disclosure concerning your mutual fund, or any material that describes the risk of this kind of investment?

85	Yes
10	No
5	Don't know
100	

13. (IF YES TO Q12) Did you read the material your bank gave you?

86	Yes
11	No
3	Don't know
100	

14. (IF OWN A MUTUAL FUND) Now I'd like to ask you about the costs and fees that may be associated with the mutual fund at your bank. As far as you know, which of the following fees are part of your mutual fund? (IF MORE THAN ONE BANK MUTUAL FUND, ASK ABOUT THE ONE PURCHASED MOST RECENTLY)

		Yes %	No %	Don't Know %
a.	A front-end sales load?	36	32	32
b.	A redemption fee?	46	25	29
c.	A management fee?	38	36	26

14a. (IF OWN A MUTUAL FUND) Did the costs and fees for your mutual fund turn out to be about what you expected, higher than expected, or lower than expected?

47	About as expected
33	Higher
10	Lower
10	Don't know
100	

14b. (IF OWN A MUTUAL FUND) Was this the first time you'd invested in a mutual fund, or had you invested in mutual funds before you purchased the fund at your bank?

50	First time
45	Invested in mutual funds before
2	Don't know
3	Refused
100	

IF NOT "YES" TO Q9f, SKIP TO Q20
IF ANSWERED MUTUAL FUND QUESTIONS, Q10b TO Q14b, READ BEFORE Q15:
Now I have a few questions about the ANNUITY you purchased at your bank.

15. (IF OWN AN ANNUITY, "YES" TO Q9f) Can you remember who initially advised you to invest in an annuity at your bank? Was it a bank teller, a bank officer, a personal financial advisor, someone else, or is this something you decided to invest in on your own?

3	Bank teller
10	Bank officer
3	Other bank employee (VOLUNTEERED)
21	Financial advisor
3	Other (SPECIFY)
49	Own decision
11	Don't know
100	

16. (IF OWN AN ANNUITY) Thinking back to when you first invested in an annuity at your bank, did someone at your bank talk with you about your investment goals, your income, and whether an annuity is suitable for you?

57	Yes
38	No
5	Don't know
100	

17. (IF OWN AN ANNUITY) Did your bank give you any written disclosure concerning your annuity, or any material that describes the risk of this kind of investment?

63	Yes
25	No
12	Don't know
100	

18. (IF YES TO Q17) And, did you read the material your bank gave you?

77	Yes
15	No
8	Don't know
100	

19. (IF OWN AN ANNUITY) Now I'd like to ask you about the costs and fees that may be associated with the annuity at your bank. As far as you know, which of the following fees are part of your annuity? (IF MORE THAN ONE BANK ANNUITY, ASK ABOUT THE ONE PURCHASED MOST RECENTLY)

		Yes	No	Don't Know
		%	%	%
a.	A front-end sales load?	32	32	36
b.	A maintenance fee?	34	42	24
c.	An asset management fee?	14	43	43
d.	A surrender fee?	49	25	26
e.	Insurance expense?	30	38	32

19a. (IF OWN AN ANNUITY) Did your annuity's costs and fees turn out to be about what you expected, higher than expected, or lower than expected?

60	About as expected
13	Higher
6	Lower
21	Don't know
100	

20. (IF ANY "YES" TO Q9) If you ever were to have a complaint, question, or problem with ANY of the accounts or investments you have at your bank, whom would you contact to complain or get more information? (REQUIRED PROBE UNTIL NO ANSWER: Anyone else?) (RECORD ALL MENTIONS)

82	Bank
11	Personal financial advisor
4	Friend or relative
5	Personal lawyer
5	Government agency (local, state or federal)
4	Consumer organization
5	Other (SPECIFY)
5	Don't know
121*	

*Multiple responses

21. In general, do you believe your bank has ever misled or misinformed you about the risks involved with your bank accounts or investments, or do you believe your bank has given you good information about investment risks?

4	Misled or misinformed
88	Good information
5	Never got this information from bank (VOLUNTEERED)
3	Don't know
100	

22. (IF "MISLED" TO Q21) Who at the bank misled or misinformed you?

15	Bank teller
39	Bank officer
13	Other bank employee (SPECIFY)
0	Financial advisor
13	Bank brochures or other written materials
6	Other (SPECIFY)
25	Don't know
111*	

*Multiple responses

23. Finally, I'd like to ask you just a few questions for statistical purposes only. Are you now married, living as married, widowed, divorced, separated, or are you single?

59	Married
2	Living as married
9	Widowed
12	Divorced
1	Separated
16	Single
1	Refused
100	

24. What is your age?

14	18-29
48	30-49
21	50-64
15	65 and over
2	Undesignated
100	

25. What is the last grade or class you completed in school?

7	Less than high school graduate (Grade 11 or lower)
28	High school graduate (including GED certificate)
4	Technical, trade, or business school after high school
27	Some college or university, but no 4-year degree
26	College or university graduate (BA, BS, or other 4-year degree received)
7	Post-graduate or professional schooling after college (including work towards an MA, MS, Ph.D, JD, DDS or MD)
1	Refused
100	

26. What is your race? Are you white, black, Asian, or some other race?

89	White
7	Black or African-American
1	Asian
1	Other or mixed race
2	Refused
100	

27. Are you now working at a paid job full time, part time, or are you not employed?

59	Full time
10	Part time
7	Unemployed or laid off
14	Retired
1	Disabled
4	Homemaker
1	Student
3	Other
1	Refused
100	

27a. Are there any children under the age of 18 who live in your household?

36	Yes
63	No
1	Refused
100	

27b. And, how many adults age 18 or older, including yourself, live in your household?

27	One
57	Two
11	Three
4	Four or more
1	Refused
100	

28. Approximately what is your annual total family income BEFORE taxes-- just tell me when I get to the right category.

8	Less than $10,000
15	$10,000 to under $20,000
13	$20,000 to under $30,000
13	$30,000 to under $40,000
19	$40,000 to under $60,000
15	$60,000 to under $100,000
5	$100,000 or more
3	Don't know
9	Refused
100	

Thank you very much for your time. Have a nice (day/evening).

RECORD SEX

44	Male
56	Female
100	

See pg. 5 — Conclusions / Recs

MUTUAL FUNDS AND THE PERSONAL TRUST ACCOUNT: FEE AND DISCLOSURE ISSUES

Standish H. Smith

Introduction

Mutual funds present a 'new' business opportunity to banks. But their use in personal trust accounts presents both advantages and disadvantages for trust beneficiaries.[1,2] (For background information on mutuals including fee structure, OCC regulations, etc., see Reference 3). This article will focus specifically on cost, disclosure and other related issues that need to be addressed by regulatory authorities if mutuals are to serve beneficiaries' interests as well as the interests of banks.

Cost Issues

'Standard' bank fee schedules for personal trust management have been rising every two-three years[3] and continue to be a major complaint of beneficiaries.[4] However, if the authority of the corporate trustee to impose its administrative policies on beneficiaries were subject to appropriate checks and balances as, for example *by granting the beneficiary practical means of moving his/her irrevocable trust to an alternative trustee,* then any additional costs associated with mutuals would not be a major issue. Indeed, fees would be a *non-issue* if irrevocable trust accounts were easily portable, full and lucid disclosure of their costs (including the *differential* cost of mutuals over a bank's 'standard' investment program) were made to beneficiaries/creators and the latter were known to be financially sophisticated consumers. But until such matters are a 'fiat accompli', there is no reason to believe that banks will not continue to raise fees and that, consequently, trust department profits will also continue to rise.[3] Indeed, mutuals appear to provide yet another strategy by which banks can legally garnish yield or principal that properly belongs to the beneficiary. *It is important to understand that reasonable fees are a critical issue for beneficiaries*, many of whom depend on their trusts to support less than an elegant standard of living.[5,6] (Federal Reserve data indicates that the average irrevocable trust managed by an affiliated bank is only about $600,000.)[7] How many times has an income beneficiary been heard to say that her fees consume the equivalent of one-third or more of trust income! Remainderpersons also have cause for concern since even a 'small' - say 50 basis point -differential in costs can markedly affect trust

growth.[1] Unfortunately, state statutes requiring a bank to reduce its general management fees on converted assets are probably 'longer on image than substance'. That is, unless such legislation prohibits *any* net increase in overall management costs to the consumer, then they may only mislead the beneficiary into thinking that his/her costs have not materially changed.

Justifying Increased Fees by Claims of Better Performance/Higher Costs

Although we have no survey data at hand, it is strongly suspected that banks converting common trust funds (CTF's) as well as individually managed assets into *internally* managed mutuals are often simply changing accounting methods and legal foundations rather than adding investment resources. Thus, if a bank sells higher fees by arguing that conversion will enhance performance but it is not apparent that it has upgraded its investment skills, then one must ask why such sudden expertise was not visited on beneficiaries' accounts heretofore! It is also apparent that banks are creating mutual funds primarily for public sale than for use in personal trust accounts because of the profit opportunity. Under such circumstances, should banks be allowed to justify charging off even a portion of their development and/or administrative expenses to beneficiaries?

Despite the fact that bank 'X' can trot out numbers to 'show' how well its mutuals have done in prior years, this is not the same as a guarantee that history will repeat. In fact, quite the opposite is as likely to be true.[8] Consequently, unless a bank can guarantee improved performance (unlikely!) or at least present numbers to demonstrate that mutuals will enhance (in what a statistician would term) a portfolio's future 'expected value' (doubtful!), any increase in fees appears unwarranted. In fact, it might be argued that beneficiaries are entitled to a fee reduction since their funds are being 'hypothecated' as seed capital for a new banking enterprise that likely did not exist at the time the trust was created and therefore would have been unknown to the trust creator!

Fiducial Obligation to Use the 'Best' Available Mutuals

It is not surprising that banks appear to be putting *internally* managed rather than *externally* managed funds in trust accounts despite the availability of a number of nationally known mutuals with exceptional track records. Granting that bank "X" has the talent to pick an outside fund with unusual promise, would it be likely to snub its own investment people and compromise its own profits by doing so? (If 'larger' banks with substantial in-house investment resources are not likely to embrace outside funds, 'smaller' banks may well view the externally managed fund as a competitive strategy for getting 'big brother's' performance on the cheap, putting upward pressure on costs and therefore beneficiaries' fees.) Notwithstanding any prior remarks about

the predictive value of past performance and noting existing statutory restrictions on the delegation of day-to-day oversight over trust investments, it could be argued that a *corporate* fiduciary nevertheless has a *fiducial* obligation under prudent man rules to search out that fund demonstrating the greatest potential and to use that fund before employing its own product. Indeed, by offering a mutual fund for *public* purchase, it could be argued that a bank not only *possesses* but has *represented* itself as *possessing* a greater investment skill than a man of ordinary prudence and therefore should be required to exercise such skill by searching out the 'best' mutuals available in the open marketplace.[9,10,11,12,13].

Interestingly, a mutual fund that appears particularly suitable for personal trust accounts is the humble index fund simply because only an index fund is so well suited to meet prudent man's *preservation of capital* stricture by assuring average market returns at *exceptionally low cost*. Indeed, the index fund is especially appropriate as an investment vehicle for trusts if only because 'active' management has generally been shown to be no more efficacious than 'passive'. (Note that the Vanguard Group has built its enviable reputation partly on the premise that minimizing costs is one dependable way of enhancing total returns!) The writer can only speculate as to why index funds are not used more frequently in personal trust accounts. What is understood is that while most mutuals generally add cost, they are not necessarily *cost effective*.

Regulatory/Legal Contexts Re Unwarranted Expenses

The introduction of mutuals into personal trust accounts may violate Third Restatement prohibitions on saddling trust accounts with unwarranted expenses. To quote *Trusts and Estates* for December 1991;

> " . . . the prudent investor rules underscores a trustee's duty to avoid unreasonable and unwarranted expenses in managing investments. First, that passive investment strategies such as the use of index funds or indexing techniques are permitted and, in some situations, may be preferred. Second, that active investment strategies inherently involve added costs which must be justified by reasonable expectation of increased reward (underlining supplied).[14]

In particular, when the total expense ratio includes a provision for reimbursement of distribution expenses (12b-1 fees) as presumably could occur with funds managed or externally or 'internally' via a subsidiary of the bank(?), we have a horrific example of an unwarranted expense which not only serves no fiduciary purpose but which may violate SEC (Sec. 28) rules against vendor kickbacks.[15] Further, such kickbacks would also appear to violate a trustee's duty of loyalty as well as statutory/case law provisions prohibiting 'secret profits' when such costs are not

disclosed.[14] (Interestingly, while Reference 16 carves out an exception when 12b-1 fees are authorized under local law or if full disclosure is made, Reference 17 does not!). Only if such fees are reimbursed to the beneficiary (an improbable event?) can a conflict of interest be avoided according to Reference 18. As an example, it is believed that Dreyfus Cash Management Fund directly or indirectly makes undisclosed rebates of 12b-1 fees to the Bank of New York. The effect of 12b-1 fees on the total expense ratio is treated in Reference 19 while their profit potential to vendors is discussed in Reference 20.

Regulatory/Legal Contexts Re Fee Structure Complexity

The fees associated with mutuals are complex.[21,22,23] But when mutual funds' fees are combined with a bank's standard fee schedule, the resulting fee structure may be incomprehensible to many beneficiaries. In the first case, the various fees/costs may not be fully and lucidly disclosed. In the other, the standard schedule may itself be discounted by 'X' basis points but only on those assets invested in mutuals as illustrated in the case by Continental Bank of Norristown, PA.[1] (It is unfortunate that when mutuals are employed as part of an investment portfolio, a bank is still forced to retain (at least a modified form of) its standard fee schedule in order to be able to tailor its fees to account size.) The point is this. If a beneficiary does not fully understand the fees being charged, how will he/she be able to take remedial action should the need arise and limited as that action might be? Again this would not be such a key issue <u>if</u> candor was characteristic of the trust relationship. But that is clearly <u>not</u> the case![4] For example, while gathering data for the recent HEIRS® survey of trust fees[1], Charlotte Ray, legal counsel for the Premiere Bank of Baton Rouge, LA, stated to the writer that one reason her bank liked mutual funds was because the fees were *hidden*! Indeed, considering the lack of financial acumen of many (most?) trust beneficiaries and the suspicion that disclosure requirements can be met via 'fine print', fees embodied into mutual funds might be viewed as a constructive violation of the fiduciary principal of 'no secret profits'. To quote Wyatt v. Union Mortgage Co., "there can be no secret profits allowed to the trustee, inasmuch *as it owes to the beneficiary the duty of <u>fullest</u> disclosure of all material facts*"[24] (underlining supplied).

Perhaps one way to sidestep both complexity and disclosure issues would be to require that fees be taken only at the account level (where they are visible) and never at the fund level (where they are, for practical purposes, invisible). (Obviously, this would require banks to develop two versions of each fund - one with a conventional fee structure for external sale and one that was free of fees for internal use.) Taking it one step further, trustees could be required to accord beneficiaries full yield with no erosion of trust principal by dint of fees on trust investments - i.e., fees on personal trust accounts would be paid from income and taken only at the account level.

Broader Regulatory Concerns

If OCC rules often appear adequately drafted to address a range of conflict of interest issues, it is unfortunate that these same rules often permit an exception whenever a specific practice is otherwise *authorized under local (state) law.* It is our experience that state banking law generally discriminates against trust creators and beneficiaries while favoring the banking interests. In fact, state law appears written as if to acknowledge that the corporate trustee of today is primarily interested in the irrevocable trust as a dependable source of continuing revenue rather than reflecting a sacrosanct obligation to place the beneficiaries' interests ahead of its own. Indeed, *practitioners* of trust/estate law sometimes act as if they were representing the interests of the banking industry when, in fact, they are being paid to represent the interests of beneficiaries and creators[2]. Perhaps this situation can be attributed to the fact that creators and beneficiaries have never before possessed a collective viewpoint or organized to express that viewpoint. Consequently, there has been little real impetus for reform. This situation can and must change but will require a concerted effort by Congress and the cooperation of appropriate regulatory agencies. Specifically, what must be swept away is the idea that a particular trustee is uniquely qualified to carry out the will of the creator, an idea that worked in a bygone era but is clearly archaic in today's business clime.[8] If the role of the trustee is to be preserved, beneficiaries must be empowered to act in their own best interests by being given oversight over the actions of trustees through remedial *federal* legislation.

Conclusions and Recommendations

Under certain circumstances, mutuals are appropriate for personal trust accounts. However, it is suggested that a) management fees be taken only at the account level and preferably only from income, b) the full and lucid disclosure of the absolute and differential costs involved with mutuals be required, and c) the informed and ongoing consent of both income beneficiaries and remainders should be obtained before mutuals are introduced into personal trust accounts. Since the ongoing conversion of trust assets provides additional profit opportunities and was initiated with stockholders' rather than beneficiaries' interests in mind, consideration might also be given to prohibiting any increase in fees and perhaps even granting beneficiaries a reduction thereof when trust assets are converted to mutual form!

FOOTNOTES

1. Fiduciary Fun, December 1993. Smith, Standish H., The HEIRS® Organization, Copyright 1993, pp.29,30,17,1,9-14.

2. Fiduciary Fun, April 1993, Smith, Standish H., The HEIRS® Organization, Copyright 1993, pp.3,4,9,10.

3. Trust Department Management Manual, Mennes, Edmund A., Schleshunoff Information Services, Inc., Austin, TX, 1991, pp.8-16,8-17,8-18,1-25.

4. A Survey of Trustors and Trust Beneficiaries, Smith, Standish H., The HEIRS® Organization, Copyright 1992, pp.45,46,36.

5. Fees Up - Service Down; The Corporate Administration of Irrevocable Trusts Needs an Overhaul, Presentation to a Meeting of the National Bank Examiners, Office of the Controller of the Currency (OCC), Washington, D.C., August 5, 1993.

6. The Corporate Trustee - A Force for Good or Evil?, Smith, Standish H., The HEIRS® Organization, 1991.

7. Trust Assets of Financial Institutions - 1992, Federal Financial Institutions Examination Council, Washington, D.C., Board of Governors of the Federal Reserve System et al, p.8.

8. Today's Fund Stars May Crash and Burn Tomorrow, Dunkin, Amy, Business Week, January 10, 1994, pp.136,137.

9. In Re Estate of Niessen, 413 Atlantic Reporter, 2nd Series, pp.1151-1052.

10. In Re Mendenhall, 398 Atlantic Reporter, 2nd Series, pp.951-955.

11. In Re Estate of Lychos, 470 Atlantic Reporter, 2nd Series, pp.136,140,144.

12. Estate of Knipp, 414 Atlantic Reporter, 2nd Series, p.1009.

13. In Re Estate of Killey, 326 Atlantic Reporter, 2nd Series, pp.373-375.

14. How the Prudent Investor Rule May Affect Trustees, Welch, Lyman A., Trusts and Estates, December 1991, p.18.

15. The Punctilio of an Honor The Most Sensitive, Brown, Peter. Trusts and Estates, April 1992, p.27.

16. Banking Insurance, Comptroller of the Currency, Banking Circular (on) 12b-1 Funds, October 31, 1986.

17. Cash Management, 16.400-Staff Letters, Opinions, Extra Fees in Connection with 12b-1 Funds or Cash Sweep Systems (FRRS 3-1596, June, 1985), Board of Governors, Federal Reserve System, Revised 6/88.

18. Fiduciary Precedents, Conflicts of Interest, Self Dealing and Divided Loyalty, p.238 (best citation available).

19. The Effect of 12b-1 Plans on Mutual Fund Expense Ratios: A Note, Ferris, Stephen P. and Chance, Don M., Journal of Finance, September 1987.

20. What Hath 12b-1 Wrought?, Oliver, Suzanne L., Forbes, July 22, 1991.

21. Fee Madness, Zweig, Jason and Grover, Forbes, February 15, 1993.

22. Pig in a Poke, Fink, Ronald, Financial World, March 3, 1992.

23. Broker Sales Techniques Can Be Adapted for Trust Business, Gossin, Robert, Trusts and Estates, October, 1989.

24. VanderKamp v. Bank of America National Trust and Savings Association, 251 California Reporter, 204 Cal App. 3rd 819, p.534.

FIDUCIARY FUN

Information and Ideas for the Modern Beneficiary and Trust Creator

Vol. 1 No. 10 December 1993

FEES AND COSTS OF TRUST ADMINISTRATION (SURVEY)

The creator of a trust can designate his own trustees regardless of whether they live (or are located) in the same state as himself or not. But if a trustee will be located in a state other than that of the creator's present domicile, the creator need only set up a living (typically revocable) trust designed to convert to an irrevocable (so called testamentary) trust at death. Otherwise, a testamentary trust 'under will' will be 'sited' in whatever state the creator happened to be residing at death and, for practical purposes, cannot later be transferred to an out-of-state trustee unless there is a reciprocal agreement in existence between both states allowing such transfers. For example, Pennsylvania has such reciprocal agreements with New Jersey, New York, Delaware, Massachusetts, Maine and Wisconsin but not with Florida, California, Virginia or Georgia. In particular, it is reported that a trust cited in Massachusetts or Florida rarely leaves, becoming a permanent source of revenue to same! Hence a beneficiary's ability to shop for more cost effective management will be severely restricted once the trust is 'activated'.

Fee policies and practices vary among banks and between banks and independent trust companies. For example, management fees charged by banks are currently being revised upward every two-three years. However, it is also true that creators (but not always beneficiaries) can sometimes negotiate rates with corporate fiduciaries especially if a) the trust corpus amount is over 3M, b) estate settlement will be included, or c) there is a substantial concentration of the trust corpus in one or more securities. Further, in some states, maximum management fees are set by statute and, if so, these limits will tend to be generous. In particular, fees quoted for management services presume that the corporate trustee will have full responsibility for investments plus all custodial functions including the filing of tax returns except as noted. Note that rates will generally be lower if a bank or independent trust company is providing only custodial and/or investment management functions but is not also acting in a fiduciary capacity (i.e. accepting the legal responsibilities of a trustee). In addition, the same rates will generally apply whether or not a co-trustee has been designated except as noted. If a trust will be subject to extraordinary court oversight as with a conservatorship or

(Continued, page 9)

STRATEGIES FOR MANAGING (OR REPLACING) A CORPORATE TRUSTEE PART II

(Part I appeared in the April 1993 edition of Fiduciary Fun)

Editor's Note

The following practical suggestions are intended as general information and cannot be guaranteed as to effectiveness in a particular situation. Caution: Some banks may assess the trust corpus for their legal expenses not only when they must defend an action brought by a beneficiary, trust creator, etc. but also whenever they find it necessary to obtain advice (legal or otherwise) in order to answer a beneficiary's/trust creator's questions/complaints.[1]

INTRODUCTION TO PARTS 1 AND 11

It is not maintained that every beneficiary should consider replacing their present corporate trustee. Indeed, there is evidence that some banks do a credible job in both money management and customer service - though that fact may not be apparent to some beneficiaries. On the other hand, there is also evidence that certain banks fail miserably as corporate trustees. In either event, it is important that a

(Continued, page 2)

IN THIS ISSUE:

HEIRS® — AN ORGANIZATION OF BENEFICIARIES FOR TRUST/ESTATE REFORM

Strategies for Managing (or Replacing) a Corporate Trustee, Part II (Continued from page 1)

beneficiary be able to recognize whether his/her bank is performing well or not and be prepared to effect a change as circumstances warrant. To these ends, this article presents an overview of the rules that fiduciaries must follow and offers both a plan and specific strategies that a beneficiary can adopt in their breech.

It is the role of the trustees to administer the trust for the sole benefit of all the beneficiaries (income beneficiaries and remaindermen). But in so doing, they must abide with the intent of the creator[2] of the trust as expressed by the terms of the trust instrument and any other ancillary 'agreements' as well as conform to relevant state and, in the case of national banks, federal statutes. Otherwise the administrative power of the trustees is absolute; they govern by majority rule with the exception that no trustee can force another trustee to resign absent a court order. In general, if one or more beneficiaries (family members, etc.) and the bank are co-trustees, the bank must seek the approval of the other trustees. In the event there is more than one 'non-bank' trustee, obviously the bank can always be outvoted. And in the event of a disagreement, any trustee can petition the court for a ruling. Furthermore, state courts are empowered to remove and/or surcharge a trustee that fails to meet its obligations. But this can be a lengthy, expensive process because generally, the burden of proof will be on the beneficiary to show why he/she deserves relief. And despite the fact that there may be numerous and valid arguments that are available to contest a trustee's performance, the problem has always been that state courts typically will offer relief only if the trustee has egregiously violated his duties. Coupled with the difficulties that beneficiaries experience in finding independent, competent and affordable counsel, it is no wonder that banks are often successful in warding off those that would challenge their continued stewardship. Nevertheless, practical experience has demonstrated that beneficiaries willing to understand the obligations of trustees—as well as the strategies that banks pursue in their efforts to keep trust accounts locked up - can often improve their stature with the bank, perhaps to the point of winning concessions or even bringing about a 'voluntary' resignation if the account is not too large (say <1M).

THE BLACK HAT APPROACH

Beneficiaries often report that their bank will not listen to or act on their complaints. And so they question whether it's worthwhile going to the trouble of presenting legitimate issues to the bank in writing. True, beneficiaries and banks both understand that it is the bank that has custody of the trust assets and therefore cannot be forced to do anything outside of a courtroom. But the point is that your letter writing effort will demonstrate to the bank that you a) have a case that will 'sell' in court and, more importantly, b) are willing to go to court for relief. Once you have made these points - and this will take time and effort on your part - the bank may have no choice but to cooperate by dealing with you in a responsive manner.

Many beneficiaries also find it difficult to confront their bank over administrative issues because the bank is a major (or sole) arbiter of the family finances. Consequently, beneficiaries sometimes feel that it is important to maintain a 'cordial' relationship with their bank lest it refuse a request for a needed principal distribution, etc. But experience has shown that beneficiaries who can disregard this psychological barrier and 'stand firm' will ultimately not only win the bank's respect. With this in mind, we present some additional strategies for the stronger at heart!

CHALLENGING THE BANK'S FEES

It is fair to state that the judiciary is aware of the trustee's obligation to place the interests of the beneficiary first. The judiciary also recognizes that the fees charged by the bank are, for practical purposes, compulsory in their nature, thus creating an inherent conflict of interest between bank and beneficiary.[3] In fact, the sensitivity of banks to this issue may, indeed, be one reason that they typically charge management fees that are somewhat lower than those offered by competing financial institutions while often making up the difference with numerous but lower visibility fees for sweep, termination, legal and other 'extraordinary' services. In any event, the fees charged to administer a trust are one issue that directly affects the welfare of the beneficiaries.[4] Consequently, a beneficiary can demand that those fees be reasonable in terms of the services provided.

Since fees vary, you may be able to demonstrate (eg. by comparing notes with other beneficiaries) that your fees are not comparable with those of other banks or, for that matter, with the fees charged for equivalent services provided by your bank to its other clients as, for example, on revocable trusts![5] In addition, it is a fact that fees charged by local banks located in the greater Philadelphia area not only tend to change in unison but also invariably move up rather than down. Hence it can be argued that fee schedules do not change as a result of competitive market pressures but instead tend to be 'administered.' For example, fee increases have been reported merely because the bank was merged into a larger institution or even when fees were fixed (often as a percentage of income) by the trust instrument. A beneficiary can also argue -and with ample legal precedent—that fees should bear a reasonable relationship to costs. Happily, the costs of running a trust department have always been difficult for a bank to assess accurately![6] Note that part of these 'costs' may include reimbursement to a third party for referring your trust. Reportedly, such fees - called 'finder's fees' - can run as high as 30% of the management fees paid to the bank and be payable for up to 5 years. Further, such fees are not necessarily disclosed to the creator or his beneficiaries. (This may be one reason certain banks discourage removal clauses!)

As a practical matter, it is probably true that most banks are successful in getting a fee agreement signed by the trust creator or, if not, at least from the beneficiaries. (A major Philadelphia Bank, for example, reportedly was able to secure a fee agreement from the creator in about nine out of ten cases.) Such agreements typically 'authorize' the bank to collect fees according to whatever its current 'standard fee schedule' happens to require. But such can be regarded more as legal smoke than as contractual commitment principally because of their unbalanced and open-ended nature.[7] Hence even in the case where the creator signed such a document, you may still be able to argue reasonably that the bank does not now nor did it ever have the authority to collect any fees. In either event, the burden of proof is on the bank to justify the amount charged and you can demand that it do so in court. Once you have the fee agreement in hand or at least something to document the fact that it will not be forthcoming, you may then want to state your position to the bank in writing. For example, you might consider stating that (in your opinion) the bank lacks authority from the trust creator to deduct fees. You might also consider demanding that the bank not only cease deducting any further fees but return all past fees with interest or face a possible future surcharge action.[8] In addition, any beneficiary who has previously signed a fee agreement might also consider rescinding same. Remember— fee concessions don't just happen. Banks are quite aware that some beneficiaries complain while others don't. Needless to say - those that don't can expect to pay higher fees than those who do!

Obtaining The Fee Authorization Agreement And Other Documentation

It's useful to determine whether or not a fee authorization agreement exists between the trust creator and bank. If one does exist, you will certainly want to obtain a copy. (If one does not exist (which is the preferable situation), you will at least want to secure written confirmation of that fact from the bank.) Note that the mere fact that you do not have a record of any fee authorization agreement - or that the bank cannot (or refuses to) furnish same - does not mean that one does not exist! Therefore, you may want to write everyone concerned with your trust such as the bank, co-trustees, other beneficiaries, the lawyer who drafted the trust/will, or even close friends of the deceased. In your letter, you may find it useful to

a. state that, as an income beneficiary (or even as a remainderman), you are entitled to all documentation that is material to the administration of your trust[9]
b. request not only a copy of the fee authorization agreement but other relevant documentation which may prove useful later such as copies of the will, trust instrument (if not part of the will), state/federal estate tax and (annual) fiduciary returns, correspondence, and particularly records pertaining to specific investment decisions
c. request that these documents be provided within (say) ten business days - since you have a right to expect not only a responsive but a prompt reply, both of which are measures of the 'standard of care' that the bank is willing to provide
d. use Certified Mail/Return Receipt Requested, marking the Certified # at the top of your letter and sending a non-certified copy by regular mail to insure service and get the attention of both your trust officer and the bank's legal department
e. have all beneficiaries/co-trustees sign your letter if possible

f. emphasize the seriousness of your request by sending copies to all interested parties including your lawyer and the bank's senior management, and, as circumstances warrant, local officials of the Office of the Controller of Currency (OCC) as well as the banking commission in your state. (See Taking Matters Up with the Feds, Fiduciary Fun, April, 1993).

Do not necessarily expect the bank to cooperate since, as you already know, banks are often not forthcoming in sharing documentation. This is particularly true in the case of fee agreements because sometimes they contain escape clauses! Case in point: virtually all of the major banks in the Philadelphia area used a standard fee agreement during the 1950's - 1970's requiring that the bank resign in the event that there was a disagreement on fees. (We are not aware of a single instance in which a bank was willing to share same with a beneficiary!) To quote from a recent Forbes article—

> David Rawson of Main Line Trust (Wayne, PA) tells of one beneficiary who retained his firm as investment adviser. For several years the bank trustee refused to reduce its fee. Finally, the heir asked the bank for a copy of the fee letter written at the time the trust was drafted. He believed the letter contained an escape clause. The bank refused to produce the letter. The heir threatened to go to court and subpoena the letter. The bank folded its hand and resigned the trust. (underlining supplied) But it refused ever to produce the letter.[10]

RAISING OTHER ISSUES

An experienced trust/estate lawyer should be able to assist in determining whether there are other actionable issues available in your particular state. While not every situation warrants retaining counsel, it doesn't hurt to take a look to see whether your fiduciary is doing as well as he might. For example, increases in fees are a common problem which you might want to target early on and later reinforce, as need be, with other arguments. Beneficiaries often have a variety of other good reasons for complaining about a trustee's general performance or failure to disclose information that is material to the administration of the trust. For example, how many beneficiaries with trusts managed by Pennsylvania banks are aware of the 1965 Pennsylvania Banking Act authorizing a beneficiary to petition the court for a replacement if the incumbent will be merged into another institution? Further, a beneficiary may wish to complain about inadequate portfolio diversification, periodic investment reviews that occur each year at the same time, the fact that the investment officer is handling 200-400 other accounts or a totally soured portfolio and/or individual investment. In particular, a beneficiary— especially a beneficiary who is also a co-trustee— can always request that his/her investment officer prepare an oral (but preferably written) explanation for a specific transaction and its relevance to trust objectives. An outside 'expert' can then be retained to evaluate same with the investment office present.[11] (The outside expert could be a member of a local chapter of the Institute of Chartered Financial Analysts or a finance professor from a neighboring university, etc.). Or a beneficiary may take issue with the fact that the bank has failed to provide readable, timely and accurate accounting statements In particular, issue may be taken with the fact that expenses have been deducted on a 'when due' basis as opposed to a 'when paid' basis. Sometimes there is difficulty in communication due to the fact that the beneficiary has moved out-of-state - perhaps even abroad - or the fact that the original trust officer is long gone due to the bank's revolving door personnel policies. In this vein, another can argue that there is no longer any linkage between the people (institution) to whom the creator entrusted his assets and the people (institution) that service(s) the account today due to merger or acquisition of the bank by another financial institution. (There also may be legitimate concern about the financial stability of the bank.) Others can complain with justification that through no fault of their own, the bank is not responsive to questions or is otherwise hostile even though the beneficiary has taken pains not to act in a provocative manner. Perhaps the bank has even threatened to punish the beneficiary through assessment of 'special' fees or litigation.[12] Further, if the will/trust was written years prior to activation, the beneficiary may be correct in complaining that the terms of the trust no longer reflect the wishes of the decedent. Alternatively, the trustee may have failed to follow the terms of the trust instrument (re investments in particular). Or perhaps, less frequently, a beneficiary may even have reason to believe that the trustee has engaged in activities which a) could be characterized as 'self dealing' (eg. transactions involving trust assets benefiting the fiduciary) or b) have yielded 'secret profits' (eg. 12b-1 fees secretly rebated to the fiduciary rather than to the beneficiary absent specific legal authority)[13]. Further, a beneficiary may be upset with an individual trustee because he has retired, moved away, is advancing in years or is experiencing poor health (including senility). But whatever your cause for legitimate complaint, the fact that you have learned to address appropriate issues and (preferably) have engaged an experienced trust lawyer to assist you will soon alert the bank that you are serious. And that, ladies and gentlemen, will make the bank sit up and listen. So write and write often.[14]

FINAL COMMENTS

The lack of a level playing field has forced some beneficiaries and their lawyers to devise ingenious methods when dealing with an 'uncooperative' bank. For example, we know a prominent New York lawyer who confides that an individual co-trustee can make it very uncomfortable for a

bank by exerting a co-trustee's prerogative to co-sign checks, co-custody the assets and receive documentation rationalizing the corporate trustee's investment decisions and principal distributions. If the bank still appears unlikely to 'cooperate', he goes on to suggest that the beneficiary designate an attorney with 'clout' (ie. one that refers business to the instant bank, has a reputation for bank litigation, etc.) as a 'special' trustee to do the negotiating!

Regardless of whether you want replace your bank or merely gain concessions or, indeed, whether you ultimately elect to retain a lawyer, it is interesting and fun to discover how far you can take things on your own. It's simply a matter of learning the rules of the game. Remember - banks abhor publicity. And they especially dislike having to defend in court, sometimes acceding to a beneficiary's wishes just prior to a scheduled court appearance. So don't get discouraged if your fiduciary appears to stonewall your efforts. Experience has demonstrated that an ability to identify legitimate issues, a willingness to assert yourself and persistence can sometimes win a voluntary resignation or at least a fee reduction or other concession. So you may find that your efforts will ultimately be well rewarded. It's clearly up to you!

(Part I of this article appeared in the April 1993 edition of Fiduciary Fun.)

---

[1] DISCLAIMER. HEIRS® is a support group primarily for beneficiaries and creators of irrevocable trusts It offers practical suggestions to those who want to improve relationships with their corporate fiduciary and to others who may be contemplating setting up a trust using a bank, independent trust company or individual as fiduciary It is not qualified to offer legal or estate planning services and will not do so For legal assistance, see a lawyer that is a specialist in trust/estate matters

[2] The creator of a trust is sometimes termed the settlor, trustor, grantor or testator

[3] We quote U.S. Supreme Court Justice Cordozo (Meinhard v. Salmon (New York District), Vol. 249, p.458)

> "Many forms of conduct permissible in the work-a-day world for those acting at arms length, are forbidden to those bound by fiduciary ties A trustee is held to something stricter than the morals of the marketplace Not honesty alone, but the punctilio of an honor the most sensitive, is that standard of behavior. As to this there has developed a tradition that is unbending . . . only thus has the level of conduct for fiduciaries been kept at a level higher than trodden by the crowd "

[4] The fees charged by some banks can be shown to be equivalent to over 30% of income! It is interesting to speculate whether the current increases in fees being promulgated by many banks have induced some to sell growth assets in order to increase the proportion of fixed income securities in the portfolio, thus masking the extent to which its fees cut into the beneficiaries' income.

[5] The term 'standard' as in "standard compensation agreement" is certainly a misnomer because the fees charged by a particular bank will vary considerably. Legitimate reasons include a) geographical location of the office servicing the account, b) account size, c) proportion of assets invested as an individual account vs common trust funds, and d) whether the trust corpus includes real property Less legitimate reasons include a) any oral 'understanding' reached with the creator of the trust, b) the beneficiary's acumen/assertiveness in raising 'points of discussion' with his/her trust officers, c) inclusion of a 'no cause' escape clause in the trust instrument/fee authorization agreement, d) whether the trust is revocable or irrevocable, and e) whether the bank is obligated to pay a finder's fee to a referring third party such as an estate planner, lawyer or accountant. Indeed, in some cases an argument might be made that the actual (as opposed to published) fee structure is discriminatory

[6] The point is reflected by the following quotations, the most recent from the trade publication Banking Week. "It's the trust department mentality -you don't fully account for the (overhead) costs of providing the services to customers over time. Further, in a recent landmark decision involving the Mellon Bank, Judge Katz declared that the fees charged by Mellon to sweep clients' daily balances bore little or no relationship to its costs in providing sweep service We can infer from his statement that Mellon must have had great difficulty in documenting its costs to the court!" (For details, see Fiduciary Fun Sept 1992) And Robert Rake, Illinois Commissioner of Banks and Trust Companies has stated that "most (Illinois banks) did not want to bother to prove their costs (in providing sweep service) in order to justify their collection." (From Trust Regulatory News, November 1992, p.6) Finally, we comment that the actual cost of running a trust department can't be too high if the (reported) reluctance of some banks to release older accounts with low, fixed fees (eg 2% of income) is any indication!

[7] In fact, the 'spurious' nature of such contracts ('adhesion' contracts in lawyers' terminology) leads one to speculate whether their purpose is mainly to discourage beneficiaries from challenging the bank's fees!

[8] To quote R.S. Kochman and W Zeena, Jr.,

> "Surely, the word most feared by a trustee is "surcharge " A surcharge action is a civil action brought by a trust beneficiary against a trustee seeking monetary relief on behalf of the trust due to an alleged breach of trust by the trustee. A trustee is guilty of a breach of trust, and is chargeable with any loss to the trust, if he/she violates a duty owed to a beneficiary The duties and obligations of trustees are ordinarily fixed by the terms of the trust agreement When there are no express or implied provisions in the trust, a trustee's duties are determined by principles and rules established by statute and by courts of equity
>
> Traditionally, courts have imposed duties and liabilities on trustees because of the special relationship between trustee and beneficiary For example, except to the extent it may be legally modified by the trust instrument, a trustee is bound to employ such care and skill as a person of ordinary prudence would exercise in dealing with his own property Therefore, if a trustee acts imprudently and the trust suffers a monetary loss due to the trustee's failure to live up to prudent person standard of care, a surcharge action is likely Obviously, when accepting a trusteeship, one must be mindful of one's legal duties and obligations to the beneficiaries Although most trustees are aware of their general duties to the beneficiaries, such as their duty of loyalty and duty to preserve and defend the trust, many fail to understand fully or even contemplate how these

duties arise in connection with the day-to-day administration of the trust. Unfortunately, many trustees learn too late, usually after a lawsuit is commenced." From Protective Measures and Considerations in Litigation, Kochman, R.S. and Zeena, Jr., W., Trusts and Estates, December, 1992.

[9] We quote from Courts Change Standards of Conduct for Trustees, Caupisi, Dominic J. in Trusts and Estates, January 1988, p.39 "The trustee has always had a duty to disclose material facts to beneficiaries which the trustee knows the beneficiary does not know and which are needed for the beneficiary to protect his or her interest." Further, quoting Coping With a New Threat, Adams, Roy M. and Howard, Carter, in Trusts and Estates, October 1989, "If the beneficiaries are to hold the trustee to proper standards of care and honesty and procure the benefits to which they are entitled, they must know what the trust principal consists of and how it is being managed. As a general rule, however, only current beneficiaries, those currently entitled to receive income or principal, are entitled to information from the trustee, unless the trust instrument provides otherwise." However, in a majority of states . . ."contingent remaindermen may demand an accounting upon a showing of mismanagement or waste of trust assets." (Further) " . . the trustee must inform the beneficiaries of all material facts in connection with a non-routine transaction before it takes place if it will significantly affect the trust estate and the beneficiaries' interests . . particularly . . . when the sale of a closely held business or the sale or lease of real estate is involved".

[10] Forbes, September 29, 1992, p.114

[11] Since the Prudent Man (Investor) rule is a rule of conduct, not one of performance, " ..it follows that documentation must be kept to record that process for future use in the event of a challenge." (Longstreth, Bevis, Tailoring Prudence: Using Circumstances, not Absolutes, to Judge Fiduciaries, Trusts and Estates, September, 1986. p.19) While it is granted that specific direction requiring corporate fiduciaries to document their investment decisions probably does not appear in the common law, nevertheless, " ..the trustee who actively and diligently exercises investment responsibility will automatically generate significant evidence of his effort." (Underlining supplied.) (Welch, Lyman W., How the Prudent Investor Rule May Affect Trustees, Trusts and Estates, December 1991 p 15.) Understandably, banks probably do not view the matter with enthusiasm because of the added paperwork burden and because "documentation can become the 'smoking gun' which provides evidence of failure to exercise investment responsibility" (Ibid, p.23) Thus, it is not surprising that banks often (reportedly) omit such documentation, preferring to create same as needed ex post facto. This policy may, however, be risky for a bank because "a court that is appropriately suspicious and inquisitive about paper trails will be able to discern whether thorough documentation is merely a cosmetic device or a genuine record of diligent and informed deliberation." (Longstreth, Bevis, Tailoring Prudence: Using Circumstances, Not Absolutes, to Judge Fiduciaries, Trusts and Estates, September 1986, p.19.)

[12] The following is excerpted from an article that appeared in Trusts and Estates magazine.

"In Gump, a difficult beneficiary inquired about accounting under a store lease with complicated provisions for determining additional rent. Sometimes a difficult beneficiary can be right. It did turn out when the court looked into it that the tenant had not been properly accounting for sales out of the leased store as compared to another store. But relations went from bad to worse between the bank and the beneficiary. The beneficiary was told she was costing the bank money by asking all these questions, the bank would have to make a charge for all the letters sent her. The bank would set up a depreciation reserve, and wouldn't invest the reserve in income producing assets. All investigation and litigation costs would be charged to the beneficiary's share directly. A memorandum was turned up and introduced at trial setting out a plan to apply litigation pressure to the beneficiary and force her to become reasonable. That may well have caused sufficient outrage at the trial level to lead to the $1 million punitive damages there. . . " (underlining supplied) From Fiduciary Responsibility in Investments, Young, Raymond, H. and Lombard, Jr., John J., Trusts and Estates, June 1985.

[13] Banking Circular, Comptroller of the Currency, October 31, 1986.

[14] Here are some additional letter writing tips.

- Stick to legitimate issues. It shows the bank you have done your homework.
- Don't ask too many questions in each letter. As you build your correspondence file, you will find that the bank will sometimes ignore certain questions or not offer a responsive answer. In these cases, you may want to ask the same question again and again! If you limit each letter to, say, two questions, it's much easier to maintain your growing letter file by topic.
- Compose each question clearly and precisely. This tactic limits the bank's ability to maneuver away from a straightforward reply
- When the bank ignores a question or fails to answer responsively, you have hit a sensitive area. You may want to repeat your question several times until your letter file clearly documents its refusal to provide the requested information.
- Type your letters. The fact that you are willing to go to this extra time and trouble shows the bank that you are serious in your purpose.

APPEAL

YOUR DONATION TO HELP DEFRAY COSTS OF
TRUST REFORM LEGISLATION IS NEEDED NOW!

While HEIRS® legislative reform will be of more immediate benefit to beneficiaries with Pennsylvania cited trusts, prompt enactment will hasten reform in other states as well. $40,000 has been pledged and another $40,000 is needed now to start the process. Our legislative consultants feel strongly that results are possible *within* one *year.* No one will fight this battle for us—each of us must do his/her share. You will be helping those beneficiaries who are critically dependent on their trust income—income that is currently being confiscated to pay bank fees—*and* yourself. Become part of an historical process—make your check to the HEIRS® Special Fund (not Gail Crane and Associates as previously advised) and mail in the enclosed envelope to: **HEIRS® Special Fund Box 292, Villanova, PA 19085**

LEGISLATIVE UPDATE

You are probably aware that the HEIRS® trust reform bill #43 has stalled in the Pennsylvania Senate Judiciary Committee due to joint pressure from the Pennsylvania Banker's Association (PBA) and the Mellon Bank. Despite our best efforts, we have been unable to induce committee chair, Eugene Scanlon (D) of Pittsburgh, to vote our bill out. If, however, the chairmanship reverts back the Republican side of the aisle, there is a good possibility that the bill would not only be voted out of Judiciary but would be promptly introduced into the Senate Insurance and Banking Committee. At that point sponsor Senator Edwin Holl (R) would be in a position to work for passage. The key is the disputed election of Democrat William Stinson over Republican Bruce Marks, both of whom wish to represent Philadelphia's Second Senate District, a matter that is currently subject to state and federal investigations. If Stinson's election is overturned in favor of Marks, then the Republicans would regain control and hopefully '43' would be on its way!

Experience with '43' has made it abundantly clear that any bill designed to provide cost effective means of changing trustees - whether from one bank to another or to an individual trustee— is going to require a strong lobbying effort. *Beneficiaries of irrevocable trusts are our only solid constituency for reform. That means that it is up to those who have serious problems with their trustees or simply want to reduce their fees to provide the necessary financial backing.* We need just a few more beneficiaries willing to support this effort with their dollars. (Even if your trust is administered out-of-state, it is in your self interest to help now because a victory in Pennsylvania will make it easier and faster for us to achieve reform in your state!) No one is going to do this for us - not the 'other guy' whose pockets you think are deeper - not the Office of the Controller of the Currency - not the American Bar Association - and (God forbid) certainly not the American Bankers Association! But I'm convinced— as so is Gail Crane Associates, the professionals we have retained to help us - that we can get the legislation passed within one year if we move quickly. Even if your contribution is not tax deductible, you'll have a once-in-a-lifetime chance to be involved in the enactment of truly revolutionary trust legislation while providing hope for thousands of other less fortunate beneficiaries whose banks are robbing them of sorely needed income.

ABA CONFERENCE ON TRUST ISSUES

Bob Whitman, a law professor from the University of Connecticut and currently Chairman of the Real Property, Probate and Trust Law Section of the ABA's Committee on Significant New Developments was responsible for instigating a recent panel discussion on new standards for removal of trustees and termination of trusts. The panel brought together some distinguished practitioners as well as academics affiliated with both the American Law Institute (publishers of the Third Restatement of the Law-Trusts) and the Uniform State Commissioners (See New Publications). If the conference came up short on innovative solutions, the audience participation segment presented a wonderful opportunity for the writer and others to argue the pressing need for reform. The conference may have generated some fire. It was learned at press time that a first ever Uniform Trust Code is in the works presided over by the Honorable Maurice A. Hartett III, a judge on the Court of Chancery in Delaware. This code, which is to be drafted over a period of years, will be sponsored by the Uniform State Commissioners and may ultimately be adopted by the same (or other) states that already subscribe to the so-called Uniform Probate Code.

If you wish to correspond with Judge Hartett, write him at the Court of Chancery, State of Delaware, 45 the Green, Dover, DE 19901. Others who will play an important role in revising the law of trusts and who would like to hear from you include: Edward C. Halbach, Jr., University of California, School of Law, Boalt Hall, Berkeley, CA 94720 and Lawrence W. Waggoner, University of Michigan Law School, Hutchins Hall, Ann Arbor, MI 48109-1215.

HEIRS® IN THE MEDIA

Since our last newsletter datelined April 1993, HEIRS® has been cited in several articles including (for the first time) two publications serving the banking and financial industries. Trust Regulatory News, a trade journal published by Bernard Garbo, a former bank examiner from the Chicago area, has mentioned HEIRS®' activities in three recent issues as well as provided coverage of litigation involving sweep and other fees. In addition, Trusts and Estates, probably the most prestigious independent magazine covering the trust industry, took note of HEIRS®' in their September (1993) issue. Most interesting was an article in the July 3rd New York Times by Andre´ Brooks focusing on beneficiaries' struggle with ever-rising fees. A follow-up article by NYT personal finance editor Winnie O'Kelley on the options available to dissatisfied beneficiaries is in progress. If you would like to share your experiences with Ms. O'Kelley, call her at (212) 556-3995.

One HEIRS® member has been writing to magazine editors suggesting they expose the egregious treatment of trust beneficiaries. He has been getting such an excellent response - perhaps because he is a beneficiary himself - that it is suggested that others try the same stunt. It may turn out to be a very cost effective way of increasing our media exposure!

LITIGATION UPDATE

A previously filed federal class action suit over the imposition of so-called 'sweep fees' (fees for investment of daily cash balances in income and principal accounts) against the Mellon Bank has been turned back despite appeals filed both in Pennsylvania and U.S. Supreme Courts. However, dismissal was based on a lack of jurisdiction rather than on the merits of the case. A similar complaint filed in federal court against the CoreStates Bank was also dismissed on October 22, 1993. However, a new but broader federal class action suit against the Mellon Bank was filed on July 28, 1993 by Chimicles, Burt, Jacobson and McNew of Haverford, PA. This suit alleges charging of sweep fees violates sections of the Securities Exchange Act of 1934, the National Bank Act as well as certain provisions of Pennsylvania statutory and common law. There have been no significant developments on this suit other than a motion by Mellon for dismissal. The banking trade press regards this suit as better drafted than the earlier one.

Two actions have also been filed recently by Richard Greenfield and Associates (also of Haverford, PA) against the Bank of America (B of A) on behalf of HEIRS® member, Kent Youngberg. One action, filed on July 30, 1993 in the Superior Court of California, constitutes a broad attack not only against sweep fees but also various other fees charged by B of A for services such as tax filings/letters, appraisals and real estate management, termination, legal, etc. The suit alleges that such 'extraordinary fees' were improperly imposed, unreasonable, exorbitant and not adequately disclosed and, in some cases, levied on trusts where the fees were fixed by the trust instrument. According to the American Banker's Association Trust Letter for November, 1993, B of A has been charged with violations of California law and the National Bank Act and specifically with conflicts of interest, breach of contract, fraud and negligence and 'a host of other misdeeds'. It is noted in the same issue that " . . . for obvious reasons, the trust banking industry is watching the case very closely." Mr. Youngberg also served as the 'class representative" in an ancillary action against the same bank. According to Trust Letter for September, 1993, this class action suit is being brought in state (rather than federal) court and involves allegations that B of A violated the National Bank Act as well as specific provisions of the California Probate and Finance Codes and the California Consumer Legal Remedies Act. The focus, again, is on sweep fees.

Meanwhile, additional legal action is being studied against other major banks in North Carolina and Florida. Stay tuned!

TRUSTEES AND TRUST INSTRUMENT: KEYS TO A SUCCESSFUL IRREVOCABLE TRUST

INTRODUCTION

You probably already know that estate planning can be a highly complex affair and one that will require the services of a skilled practitioner for best results. What is less obvious is that an estate plan should be conceived, put in place (and constantly updated) years before it will be 'activated'. To commence your plan, it is suggested that you consult any of the many estate planning guides available[1]. It will soon be discovered that there are a variety of strategies available and that some may be better suited to your particular circumstances than others. In particular, trusts, both the revocable and irrevocable variety, can provide savings to your estate. And because the irrevocable trust also provides tax advantages, it is often the estate planning strategy of choice. If you have already reached a decision that an irrevocable trust is appropriate to your circumstances, then your next job is to find one or more suitable trustees and to draft the trust agreement itself. The selection of the trustees and the proper drafting of the trust instrument will have an critical effect on how your beneficiaries' future financial needs will be met.

A parent seeking to provide wealth management as well as tax advantages for his spouse or children (or grandchildren) may find that an irrevocable trust can be advantageous. In a trust under will (a so-called 'testamentary trust'), the spouse or children can begin to receive income from the trust assets that may continue for a designated number of years or a lifetime. Then, at the death of the income beneficiaries, the assets may pass to their decedents (or to charity if it is a "charitable remainder trust") 'free' – with certain limitations – of additional estate (death) taxes. But whatever form an irrevocable trust may take, the trust creator (sometimes termed the "trustor," "settlor," "grantor," or "testator") must decide whether the responsibility for managing the assets will be borne by one or more individuals (perhaps the beneficiaries themselves) or a corporate trustee. Some will prefer to use a trusted friend or relative who can be counted on to have the beneficiary's interests at heart presuming that someone can be found that has the necessary financial expertise and is young and sufficiently healthy to outlive the trust. The trust instrument will (essentially) regulate the management of the trust and both the beneficiaries and the trustee(s) will be bound by its terms. Indeed, while state statutes typically set forth minimum standards of fiducial conduct (e.g., an investment policy that is consistent with the "Prudent Man/Investor Rule", duty of loyalty, impartiality towards beneficiaries, etc.), the trustee(s) will have exclusive administrative discretion in handling various administrative matters such as the investment of trust assets, principal distributions, mediating disputes between the beneficiaries, etc.. In fact, experience suggests that the degree of discretion exercisable by a

trustee is so considerable that beneficiaries are often reluctant to stand up for their own rights. Hence when questions arise regarding the trustee's investment performance, accounting statements, principal distributions—not to mention fees—it is essential that the beneficiaries be properly prepared to deal with such issues. The advantage of using a trusted, knowledgeable friend or relative as a trustee - aside from the fact that an individual may serve gratuitously - is simply that such a person in more likely to have the beneficiaries' interests at heart. But if an individual is not available to serve, you will then need to choose a corporate fiduciary. In this event, it is a good bet that an independent trust company (private fiduciary), especially a younger company anxious for business, may prove more cooperative than a bank.

While it is suspected that trustees - especially the corporate variety - prefer to have maximum control, it is our opinion that beneficiaries' interests are better served if they are equipped to monitor the administration of their trust and have adequate means to take effective remedial action as might later prove necessary. In pursuit of these goals, this article identifies less obvious but nevertheless practical issues that must be considered if the trustees and the trust instrument are to work for - rather than against - the beneficiaries' interests.

(Additional ideas may be found in Selecting a Beneficiary-Friendly Corporate Trustee including Practical Trust Instrument Tips available from the HEIRS® organization).

THE LEGAL CHALLENGE

In setting up an irrevocable trust, the creator typically will hand over the responsibility for its administration to a third party - perhaps an individual, bank, or independent trust company. If the trustee does his job well, the beneficiaries will have few complaints. However, because of the immense degree of authority delegated to the trustees (or their successors) by the trust instrument, an improper choice can face the beneficiaries with problems that may outweigh any tax savings or other goals that the creator might have had in mind. Indeed, experience shows that it is far better to choose with utmost care than inflict the beneficiaries with the task of removing an unsatisfactory trustee through the courts. One reason is that state statutes and case (common) law do an excellent job of protecting the 'property rights' of the deceased. One of those rights, of course, is the creator's prerogative to name his own trustees. Unfortunately for beneficiaries, the law, by deferring to the wisdom of the creator, provides corporate fiduciaries with a ready defense if and when their stewardship might be challenged. So it is the beneficiaries—the entities that the trust was designed to protect in the first place—who often will have little practical recourse if the trustees perform improperly. Thus while a trust can be a wonderfully flexible instrument for assuring that family money will serve family purposes once the creator has departed, it is critically important that its provisions be designed to minister primarily to the needs of the beneficiaries rather than simply guarantee fee base to a professional fiduciary. Indeed, there is an obvious and profound difference in motivation between a family member or longtime family friend who agrees to serve gratuitously, however ineptly, and a professional who undertakes the trustee function for profit. The Supreme Court could not have appreciated the difference or, indeed, anticipated how profitable the business of trust management would become when in 1901, it set

(Continued, page 15)

Fees and Costs of Trust Administration (Survey) *(continued from page 1)*

guardianship, higher fees may apply. Rates will not necessarily be identical to those charged on so called 'living' (typically revocable) trusts.

Banks also levy a number of other miscellaneous charges for 'special' services such as investment of cash balances (so called 'sweep' fees), termination, tax letters, handling business matters (such as rent collection) as well as for out-of-pocket expenses including legal costs (to defend a surcharge and/or removal action) and brokerage. Often such fees will not be disclosed in the form of a printed fee schedule. In particular, termination and tax letter fees may or may not be imposed depending on whether fees have been fixed by the trust instrument and/or there are special fee arrangements between the bank and the beneficiary(ies). Further, miscellaneous charges indicated as 'negotiable' in the following tables are generally only negotiable by the creator rather than by the beneficiaries.

Minimum acceptable account size is sometimes negotiable, particularly if the account is expected to grow appreciably in the future. Further, some banks have established policy regarding how fees will be calculated (on income, principal or both) as well as on how fees will be charged - whether to income, principal or both. In general, however, the latter is subject to negotiation unless specified in the trust instrument or dictated by statute (as in New York).

The tables on the following pages report the management and other fees currently being charged on irrevocable personal trusts by major banks and independent trust companies (so called 'private fiduciaries') in the Greater Philadelphia area as well as by a number of banks in other major metropolitan areas. Information relating to miscellaneous charges has typically been obtained over the telephone from the person specified in the notes accompanying the 'Name of Bank or Independent Trust Company'. Such information, while believed to be accurate, may be subject to discrepancies and should be verified.

TRUST MANAGEMENT AND OTHER FEES (1)

Name of Bank or Ind. Trust Co. (2)	Fee information available as of ____ (1)	Minimum Fees		Income Fee % (3)	Combined Management Fee on Principal and Income by Account Size: CTF/IIA (3)					Fees on prin. deducted ____ (4)	Fees deducted how? (5)	Other Fees					
		Common Trust Fund (CTF)	Individually Invested Account (IIA)		$250,000	$500,000	$1,000,000	$2,000,000	$3,000,000			Sweep fee (per $100 of invested cash) (6)	Distributions	Tax Letter (7)	Termination (on prin.) (8)	Non-income producing assets (% of prin.)	Real estate sales (% of prin.)
PHILADELPHIA AREA BANKS (IN ALPHABETICAL ORDER)																	
Bryn Mawr Trust	1/1/93	$750	$1,500	6%(a)	$2,100	$4,200	$7,900	$12,800	$16,200	Quarterly	Inc fr. inc./ prin. fr. prin	40¢	None	$50 up	None	Negotiable	3% (brokr) 6% (no ")
Continental	7/1/93(a)	$1,000	$2,000	None	$3,687/(b) $2,375(c)	$7,375/(b) $4,750(c)	$14,750/ (b)(d) $9,500 (c)(d)	$27,500/ (b)(d) $15,000 (a)(c)	$40,000/ (b)(d) $15,500 (c)(d)	Quarterly	50% inc./ 50% prin	None	None	None	None	Same as on principal	Not available
Core States	9/23/93	$1,000	$5,000	6%	$2,475/ $2,475	$4,950/ $4,950	$8,650/ $8,650	$13,550/ $13,550	$17,700/ $17,700	Monthly	50% inc./ 50% prin	60¢	None	$35-$70(a)	None	75%	3% (brokr) 6% (no ")
First Fidelity	11/15/93	$1,000	$2,500	6%	$2,350/ $2,350	$4,700/ $4,700	$8,400/ $8,400	$13,800/ $13,800	$18,200/ $18,200	Quarterly	see above	50¢	None	$20 up(a)	(b)	Same as on prin	3% (brokr) 6% (no ")
Frankford Bank	10/27/93	$1000-$1500	$1,500	6%	$2,100/ $2,225	$3,700/ $4,450	$6,400/ $6,400	$11,800/ $13,800	$17,200/ $19,200	Quarterly	Inc fr inc prin from prin	None	Each ck > $12 per yr is $8(a)	$65-$105	2% 1st yr; 1% 2nd yr (b)	(c)	3% (brokr) 6% (no ")
Lehigh Valley Bank	9/8/93	$500	$900	5.5%	$1612.50/ $1,800	$3,118.75/ $3,475	$5,493.75/ $6,075	$9,393.75/ $10,275	Negot if ≥2M	Quarterly	Inc fr. inc./ prin fr prin	40¢	None	$35 up	(a)	Negotiable	Not available
Mellon	11/18/93	$500		None	3,750/ $3,750(a)	6,000/ $6,000(a)	$10,000/ $10,000(a)	$16,000/ $16,000(a)	$19,500/ $19,500 (a)(b)	Monthly	40% inc/ 60% prin.	50¢	None	None	None(c)	Not available	3% (brokr) 6% (no ")
Meridian Bank	11/15/93	$2,000	$3,000	None	$2,500/ $2,500	$5,000/ $5,000	$9,000/ $9,000	$14,000/ (a) $14,000	$19,000/ (a) 19,000	Quarterly	100% inc	None	None	None	None(b)	Negotiable	Not available
PNC Bank	10/21/93	$2,000	$2,000	None	$2,500/ $2,500(a)	$5,000/ $5,000(a)	$9,500/ $9,500(a)	$15,000/ $15,000(a)	$19,500/ 19,500(a)	Monthly	Not available	None	None	None(b)	None(b)	Negotiable	Negotiable
Provident (PNC)	*FOR RATE INFORMATION, SEE PNC BANK, PITTSBURGH, PA*																
LOCAL PHILADELPHIA AREA INDEPENDENT TRUST COMPANIES (IN ALPHABETICAL ORDER)																	
Glenmede Trust Co	11/15/93	Min fee $9,000 Min acct size = 1M		6%	N.A	N.A	$9,000 (min)	$13,800	$17,200	Quarterly (a)	Negotiable	None	None	None	None(b)	Negotiable (c)	None
Main Line Trust	11/13/93	$7,500	$7,500	None	Not applicable	Not applicable	$9,000/ $9,000	$16,000/ $16,000	$21,000/ $21,000(a)	Quarterly	50% inc./ 50% prin.	None	None	None	(b)	Not available	Not available
The Pennsylvania Trust Co.	11/22/93	$500		6%	Not applicable	$3,700(a)	$7,400(a)	$14,800(a)	$22,200(a)	Quarterly	Negotiable	60¢	None	None	None	Negotiable	None
Pitcairn Trust Co.	11/20/93	$14,000 (a)		None	Not applicable	Not applicable	Not applicable	$14,000	$21,000	Quarterly	Negotiable	None	None	None	None	Negotiable	Negotiable
Rittenhouse Trust Co	11/22/93	$10,000		None	Not applicable	Not applicable	$10,000	$20,000	$27,500(a)	Quarterly	50% inc./ 50% prin.	None	None	None	None	Negotiable	Negotiable

BANKS LOCATED IN STATES OTHER THAN PENNSYLVANIA (IN ALPHABETICAL ORDER BY STATE)																		
B of A Riverside, CA	10/21/93	$3,850	$3,850	None	$4,500/(a) $4,500(a)	$7,750/(a) $7,750(a)	$13,750/ (a) $13,750(a)	$24,750/ (a) $24,750(a)	$34,250/ (a) $34,250(a)	Quarterly	50% inc./ 50% prin.	None	None	(b)	(c)	$750 per asset per year	Not available
Wells Fargo San Fran, CA	10/27/93	$1,000	$1,000	None	$3,000/ (a) $3,000 (a)	$6,000/ (a) $6,000 (a)	$12,000/ (a) $12,000 (a)	$22,000/ $22,000	$30,000/ $50,000	Monthly	50% inc./ 50% prin.	None	None	(b)	(c)	$500 min. per asset per yr.	Hourly rate
Shawmut Hartford, CT	10/22/93	$3,840	$3,840	(a)	Not applicable	$6,275/(b) $6,275(b)	$10,175/ (b) $10,175(b)	$16,475/ (b) $16,475(b)	$21,775/ (b) $21,775(b)	Monthly	Negotiable	25¢	None	None	Security transfer costs only	Not available	Not available
Security Trust Wash,DC	10/22/93	$1,750	$3,000a	5%	$2,625/ $2,625	$5,250/ $5,250	$8,000/ $8,000	$13,500/ $13,500	$18,000/ $18,000	Quarterly	Inc. fr. inc./ prin. fr. prin.	None	.5% on prin.	Min. $250	.5% on prin.	(b)	3% (brkr) 6% (no *)
Bank of Delaware Wilm, DE	10/21/92	$1,000	$1,000	None	$2,500/ $2,500	$5,000/ $5,000	$8,500/ $8,500	$13,500/ $13,500	$17,500/ $17,500	Monthly or quarterly	Negotiable	None	None	None	None	None	Not available
Palm Beach Natl Bank	11/4/93	Not applicable(a)	$3,500	None	Not applicable	$5,000	$10,000	$19,000	$26,000(b)	Monthly	Follows instrument	None	None	$65	None	Negotiable	Negotiable
Bank One Indianapolis, IN	9/17/93	$800	$800	None	$2,050/ $2,050	$3,800/ $3,800	$7,050/ $7,050	$12,050/ $12,050	$16,050/ $16,050	Quarterly	100% inc.	60¢	(a)	Min. $125	.5% on prin.	Variable	Variable
Mercantile Balt., MD	9/20/93	$2,000(a)	$3,500	Variable(b)	$2,061.25/ (a) $2,425(c)	$4,122.50/ (a) $4,850(c)	$6,927.50/ (a) $8,150(c)	$10,136.25 (a)/ $11,925(c)	$12,601.25 (a)/ $14,825(c)	Quarterly	Inc. fr. inc./ prin. fr. prin.	None	Up to 2% (d)	None	.5%	Same as on prin.	Up to 9% (w or w/o broker)
Fleet Boston, MA	11/20/93	$3,000	$5,000	7-8%(a)	Not applicable	$5,600(b)	$11,200(b)	$18,400(b)	$25,100(b)	Quarterly	Negotiable	None	None	None	None	Not available	Negotiable
NBD Bank Detroit, MI	10/25/93	$1,500(a)	$1,500(a)	None	$3,200/(b) $3,200(b)	$4,200/(b) $4,200(b)	$8,200/(b) $8,200(b)	$15,200/ (b) $15,200(b)	$22,200/ (b) $22,200(b)	Quarterly	Negotiable	None	(c)	(d)	Min. $500	Negotiable	Not available
Bank of NY NY, NY	9/28/93	$7,500	$7,500	None but see (a)	Not applicable	$7,500/(b) $7,500(b)	$12,440/ (b) $12,440(b)	$20,440/ (b) $20,440(b)	$28,440/ (b) $26,440(b)	Annually	50% prin./ 50% inc.	25¢	1% on prin.	None	1%	Not available	1%
U.S. Trust NY, NY	9/21/93	$400,000(a)	$1.5M	None	Not applicable	$5,500/(b) $7,000 (b)	$9,250/(b) $12,000(b)	$16,750/ (b) $22,000 (b)	$24,250/ (b) $32,000(b)	Quarterly	(c)	None	None	Min. $500 (d) up to $100,000 prin.	(a)	Negotiable	Negotiable
Wachovia Winston-Salem, N.C.	9/20/93	$1,500(a)	$2,000(a)	None but see(c)	$2,000/ $2,500	$4,000/ $5,000	$7,200/ $9,000	$11,200/ $14,000	$14,400/ $18,000	Quarterly	50% inc./ 50% prin.	None	(b)	None	(c)	Not available	2-6%
Society Natl Bank Cleve.OH	10/21/93	$1,500	$1,500	None	$2,325/(a) $2,325(a)	$4,350/(a) $4,350(a)	$8,300/(a) $8,300(a)	$14,800/(a) $14,800(a)	$20,300/ (a) $20,300(a)	Quarterly	Negotiable	50¢	1%	$75 min.	1%	Negotiable	Negotiable

(1) Information is based both on printed schedules and telephone contact and is believed to be accurate as of the effective date noted. However, this information is subject to change and cannot be guaranteed. In general, all vendors reserve the right to impose additional fees or change fee schedules unless otherwise noted. Management fees are currently being upward every 2-3 years. Brokerage fees are not shown but typically will be charged at institutional rates (4-10¢ share). Some banks show same as a line item.
(2) See notes for address and name/phone number of person to contact.

(3) If a separate fee is charged on income, annual throw off assumed to be 4% on principal.
(4) Income fees may be taken more frequently, perhaps even as income is received unless specified otherwise.
(5) Method specified is general policy. But this is often negotiable with either the creator or the beneficiary.
(6) For example, 60¢ on $100 of invested cash is equivalent to a charge of 60 basis points or .006 (.6%) on income. The rate on an APR (annual percentage rate) basis will depend on the length of time the cash is invested prior to distribution. If income receipts are distributed monthly and it is assumed that each $100 of income is invested for an average of 15 days, then the APR rate can be estimated by multiplying the rate in basis points by 24. For example, a 60¢ charge per $100 of invested cash is equivalent to an APR rate of 60x24=1440 basis points or 14.4%.
(7) Fee may depend on the number of income beneficiaries as well as on gross revenue. Fee is for a tax letter - not for filling state/federal (1041) fiduciary returns - unless otherwise indicated.
(8) May depend on when trust was initiated. Older trusts not subject to current fee schedules may impose same.

NOTES

*Banks are ranked by the size of management fee charged on a 2M IIA account from 1 (lowest) to 17 (highest). The number of ranks does not equal the number of banks due to ties. AVERAGE MANAGEMENT FEES: PA banks = $13,922; Banks in states other than PA = $17,002; All banks = $15,719; Independent trust cos. = $15,720. CAUTION: Rankings based on overall costs may vary from those presented.

LOCAL PHILADELPHIA AREA BANKS (IN ALPHABETICAL ORDER)

Bryn Mawr Trust *4 Bryn Mawr, PA 19010 Contact: Michael Thompson at (215) 526-2434	(a) Stock dividends may be considered as income.	**Continental *10** (Affiliate of MidAtlantic) Main and Swede Streets Norristown, PA 19401 Contact: Shel Wedemeyer at (215) 278-4297	(a) Bank compensation schedule dated 7/1/93 guaranteed for two years from account inception. (b) Fees shown are higher than for an IIA account because mutual funds are used exclusively in lieu of in-house collective fund. Fees shown include a bank management fee plus a 1% principal fee charged for a balanced income/equity mutual fund. Other mutual funds may be used with fees on principal varying from .88% (short to intermediate govt.'s fund) thru .98% (growth equity), 1% (balanced income/equity) to 1.63% (international equity). (c) These fees discounted by 50% on any monies invested in the Compass Capital Group of Funds or by 30% if invested in fixed income securities (at the direction of the grantor). (d) Fees negotiable on 1M up.
CoreStates *6 10 Floor Center Square West Philadelphia, PA 19101-7618 Contact: Sue Doherty at (215) 973-3728	(a) Max. fee is for six income beneficiaries and $250,000 trust income. Fee is "optimal"; however not clear whether federal fiduciary return would be furnished without charge other than to a co-trustee.	**First Fidelity Bank *7** 135 S. Broad Street Philadelphia, PA 19109 Contact: Mark Walton at (215) 985-7149	(a) Depends on number of letters and gross revenue. (b) 2% on principal less total of income and principal fees paid to date.
Frankford Bank *7 601 Dresher Road Horsham, PA 19044 Contact: Elaine R. Kimmick at (215) 956-7108	(a) May charge 2% for substantial or excessive withdrawals in the first year. (b) Up to 1% thereafter. (c) Same as principal fee on an IIA account.	**Lehigh Valley Bank *1** 65 E. Elizabeth Avenue Bethlehem, PA 18018-6520 Contact: John P. Pelcheck at (215) 861-1123	(a) If account terminates in less than one year, a full year's fees will be charged. If account terminates after one year, one quarter's fees will be charged.
Mellon *2 Mellon Bank Center Philadelphia, PA 19101 Contact Glen Deibert at (215) 553-3038	(a) Includes $1500 base fee. (b) Negotiable over 5M (c) Unless an older trust not subject to current fee schedule.	**Meridian Bank *8** 55 Valley Stream Parkway Malvern, PA 19355 Contact: J.L. Keefer Hugill at (215) 251-7982	(a) Negotiable if over 2M. (b) Full year's mgt. fee due if terminated in less than 1 year.

PNC Bank *10 Pittsburgh, PA 15265 Contact: Albert P. Knowles at (412) 762-3318	(a) Any monies invested in a PNC mutual fund are exempt from these fees. Principal fees will depend on the choice of fund and will vary from .4% (index equity), .65% (intermediate govts.), .9% (balanced or aggressive growth) to 1.2% (international equity) on principal. (b) No extra charge if account is subject to latest fee schedule. Otherwise, a fee may be charged.	**Provident Bank (A PNC Affiliate) *10** 17th and Chestnut Streets P.O. Box 7648 Philadelphia, PA 19101 Contact: Joanne Cichetti at (215) 585-5969	

LOCAL PHILADELPHIA AREA INDEPENDENT TRUST COMPANIES (IN ALPHABETICAL ORDER)

Glenmede Trust Co. 229 S. 18th Street Philadelphia, PA 19103 Contact: Bill Levy at (215) 875-3270	(a) Income fees deducted every two weeks. (b) Unless "special or extra ordinary services have been performed for which compensation has not been received." (c) May waive fee if Glenmede has no responsibility.	**Main Line Trust** 111 Wynnewood Avenue Wayne, PA 19087 Contact: David Rawson at (215) 975-9700	(a) Negotiable above 3M. (b) Equivalent to 6 months fee if terminated within one year.
The Pennsylvania Trust Co. 5 Radnor Corporate Center Suite 452 100 Matsonford Road Radnor, PA 19087 Contact: Paul Irwin at (215) 975-4300	(a) Fees are negotiable across the boards depending on the amount of responsibility undertaken.	**Pitcairn Trust Co.** One Pitcairn Place Jenkintown, PA 19046 Contact: Clark D. Pitcairn at (215) 881-6113	(a) Uses common trust funds exclusively. International equity fund available at 1.2% on principal.
Rittenhouse Trust Co. Two Radnor Corporate Center 100 Matsonford Road Radnor, PA 19087-4514 Contact: Charles J. Ingersoll at (215) 971-9300 or (800) 847-9583	(a) Negotiable over 50M.		

BANKS LOCATED IN STATES OTHER THAN PENNSYLVANIA (IN ALPHABETICAL ORDER BY STATE)

Bank of America *18 3737 Main Street Riverside, CA 92501 Contact: Melissa Terrett at (909) 781-1380	(a) Includes base fee of $750. Principal fees negotiable above 6M. Fee schedule same for all B of A offices. There is a charge of $30 per security when setting up a trust. (b) Filing of tax returns and tax letter extra. (c) .8% on principal plus $30-40 per security.	**Wells Fargo Bank *17** 420 Montgomery Street 5th Floor MAC: 0101-052 San Francisco, CA 94104 Contact: Kenneth R. Williams at (415) 855-6781 or (415) 396-3627	(a) If a co-trustee shares investment responsibility, add .24%. (b) $300 minimum for tax fillings and tax letter. (c) Unless stipulated in trust document.
Shawmut Bank *13 Personal Trust Division 777 Main Street MSN 242 Hartford, CT 06115 Contact: Joseph R. Giangreco at (203) 240-7845	(a) 7% on 1st $200,000 of income; 6% on balance. (b) Includes base charge of $875 on irrevocable trust accounts.	**Security Trust *5** 1501 Pennsylvania Ave. NW P.O. Box 96632 Washington, DC 20090-6632	(a) Minimum fee is $3500 "in which prior consultation on specific investment transactions is required" or . . . if there is a co-trustee. (b) .85% on first .5M; .35% on next 2M. (c) For property valued up to .5M.

Bank of Delaware *5 (A PNC Affiliate) 222 Delaware Avenue Wilmington, DE 19899 Contact: Clyde Kessinger at (302) 429-2159		**Palm Beach National Bank and Trust Co. *15** 125 Worth Aveoue, Suite 100 Palm Beach, FL 33480 Contact: April A. Hicks at (407) 627-1776	(a) Individually managed accounts only. (b) Negotiable if over 5M. (c) Tax filings: min. $75 but fee is negotiable.
Bank One *3 Bank One Trust Group Bank One Tower Suite 1501 P.O. Box 7700 Indianapolis, IN 46277-0115 Contact: Gail Randall at (317) 321-3843	(a) If distributions exceed four per year, charge is $3.00 each. (b) Includes filings.	**Mercantile Safe Deposit & Trust Co. *2** Two Hopkins Plaza Baltimore, MD 21201 Contact: Barry R. Lavenstein at (410) 237-5157	(a) At least 90% of principal must be invested in collective funds. (b) 8% on 1st $25,000; 6% on next $25,000; 4% on next $25,000; 3.5% on amounts over $25,000; 8% on income from rents, ground rents and mortgage interest. (c) Mutual funds also available for accounts >$50,000. (d) Depending on whether discretion must be exercised.
Fleet *14 75 State Street Boston, MA 02109-1810 Contact. Jean C. Reis at (617) 346-2374	(a) 8% on 1st $120,000; 7% on balance. (b) .6% on principal for fixed income securities.	**NBD Bank *11** Trust Division Southeast Michigan P.O. Box 330222 Detroit, MI 48232-6222 Contact: William Hartman at (313) 271-7711	(a) Minimum account size is generally $250,000. (b) Includes $600 base fee. Fees apply only to marketable securities and are negotiable for accounts of unusual size or with substantial concentration in one or more securities. Mutual funds also available without extra charge. (c) $20 fee for each purchase/deposit or sale/withdrawal of a security. (d) Federal/state quarterly estimates are $60; minimum charge for federal/state 1041's is $215; payment of Michigan iotangibles tax is $60. Charges may or may not include tax letter.
Bank of NY *16 1290 Avenue of the Americas (at 51st Street) 3rd Floor New York, NY 10104 Contact: John J. Cullen at (212) 408-4541	(a) 6% charged on gross rents. (b) If principal exceeds $400,000, additional base charge of $1,500 applies.	**U.S. Trust *17** 114 W. 47th New York, NY 10036 Contact: Thor Thors at (212) 852-3932	(a) If entirely invested in fixed income funds, rate is $31,250 on 5M, $56,250 on 10M with a 5M minimum. (b) Includes base fee of $2,000. (c) Quoted 50% on income and 50% on principal but subject to recent change in statutes. (d) $750 if betweeo $100,000 and $500,000. Otherwise negotiable. Maximum is $1500 on CTF accounts, $2,000 on IIA accounts. (e) Trusts created prior to 8/6/84; termination fee will be charged.
Wachovia Bank of North Carolina *8 P.O. Box 3099 Winston-Salem, NC 27150 Contact: Anne W. Shuford at (919) 770-7425	(a) Plus a 1% charge on principal to set up trust if Wachovia did not serve as executor. (b) Maximum fee $1500 (CTF account) or $2000 (IIA account). (c) Costs of title change(s) will be charged. See also (b).	**Society National Bank *9** 127 Public Square Cleveland, OH 44114-1306 Contact: William G. Caster at (216) 689-5013	(a) Mutual funds available at additional charge of .3% on principal.

***Trustees and Trust Instrument** (continued from page 9)*

forth the legal framework within which private trusts are presently administered.

> *"[I]t is the duty of the court to refuse to remove a trustee at the mere whim or caprice of the beneficiary. There should be a substantial reason appearing to the court before it removes the trustee, who enjoyed the confidence of the person who created the trust and who by reason of his fitness for executing it, was empowered to act as trustee. The duties of a trustee are frequently onerous, especially so in large estates, and their performance is sometimes necessarily attended with a disagreement between the trustee and the cestui que trust (beneficiaries). When this occurs and the trustee has acted within the authority imposed upon him by the trust, he should be sustained by the court. He is not to be deprived of his office simply because the cestui que trust would have acted differently, and, possibly, more in his own interest than for the protection and success of the trust estate."*[2] *(Brackets and underlining supplied.)*

In contrast to a bygone era when banks treated beneficiaries in a fully responsible manner, enlightened creators today often demand a clause in the trust instrument permitting the beneficiary to replace an unsatisfactory trustee, evidence enough that beneficiaries can no longer undergo the expense of traditional legal 'solutions' to redress administrative injustice.

But perhaps the need to 'protect' the trustee also reflects an underlying presumption that most beneficiaries, given the option, would prefer to have immediate possession of the trust assets in order to shuck the shackles of ordinary life and run off to Rio! However true in specific situations, experience shows that this assertion does not apply to most HEIRS® beneficiaries whose concerns today relate primarily to poor investments, rising fees and inadequate service rather than instrument restrictions on invasions of principal. In any event, removing an unsatisfactory trustee is presently very difficult and expensive. Even if independent, affordable and competent counsel can be located, typically the beneficiary must pay his own legal fees while the trustee will take his legal costs from the trust assets! In fact, it is not unknown for a bank to consume a major fraction of those assets while 'defending the trust' in complete disregard for the needs of the beneficiary. Until such time that a limit is placed on the amount of legal fees and costs that may be reimbursed from the trust corpus or, alternatively, trustees are precluded from challenging a request to step aside - we will continue to have a situation that is best described by noted New York trust/estate attorney, Edward Schlesinger who, at a recent American Bar Association discussion on standards for trustee removal, opined that "bringing a removal proceeding is like . . . asking the beneficiary to dig his or her own financial grave."[3] We repeat - a creator who wants his trust to work for his beneficiaries will choose his trustee(s) with care.

SAFETY OF ASSETS

There are a number of considerations which will influence a creator's decision to use either a 'corporate' trustee (ie. a bank or an independent trust company) as opposed to an 'individual' trustee - typically a relative, family friend, lawyer or other private individual. Perhaps the principal advantage of banks is that they are regulated by state and, in the case of national banks, federal banking law and hence are highly unlikely to embezzle the trust assets. Similarly, independent trust companies also serve as 'corporate trustees', typically holding trust powers granted under state authority. While independent trust companies are not banks, they are (reportedly) subject to the same regulations as banks and, at least in Pennsylvania, are audited just as frequently. Least regulated is the private individual whose ability to be sued for improper administration is limited to his/her personal resources as contrasted to corporate fiduciaries whose pockets are deeper. Principals in money management firms also act as individual trustees and, as such, can and do administer irrevocable trusts without holding trust powers.

Theft can be a serious problem with individual trustees. To quote a participant at the recent ABA panel discussion[3] on removal standards - "banks don't steal and lawyers (among others) sometimes do. Here in New York, for example, the client security people pay out about a third of their distributions for thieving *from* trust accounts." (Note: 'client security people' is apparently a reference to bonding companies). Of course, lawyers and others who make a business of referring trust clients to banks will argue other advantages for using a bank as trustee. But none, in the writer's opinion, is as clear cut or, indeed, as compelling as a corporate fiduciary's capacity to protect (at least the nominal value of!) the trust assets.

CONTINUITY

The corporate trustee has another advantage over an individual trustee in that it can more easily provide for administrative continuity. How many creators are able to tap a list of qualified relatives, friends, etc. willing (eager?) to serve successively as necessity might dictate? On the other hand, while the creator may have done business with and have a high regard for bank "X", it is highly unlikely that he will ever have the opportunity to become acquainted with the multiple trust officers who undoubtedly will serve his beneficiaries' account in the future. Experience demonstrates that trust department staffing of many banks is constantly changing, aggravated no doubt by the current wave of bank mergers and acquisitions. The point was investigated in a 1991 HEIRS® survey[4] of beneficiaries whose trusts were bank managed. Interestingly, only 10% of

HEIRS® members responding to this survey indicated that their current officers were the same individuals initially assigned to their accounts. Furthermore, beneficiaries responding to the survey indicated that the number of administrative officers as well as the number of investment officers assigned over the years each varied from one to twenty-two. Indeed, the tenancy of an individual officer - whether responsible for administrative or investment matters - varied from an average of about 13.5 years for long term trusts (54-81 years duration) to about 4 years for trusts established less than 27 years ago.

COMMUNICATIONS

Good communications is often cited as key to keeping beneficiaries content. In the survey referenced above, HEIRS® members reported that good communication was not a strong point of bank trust departments. Over 50% of survey respondents complained that, at least on occasion, their trust officers would not talk or write to them in a responsive manner. (It is important to note, however, that HEIRS® members do not necessarily represent the views of all trust beneficiaries since those that contact us are typically already dissatisfied with bank management.)

On the other hand, good communications is sometimes cited as a selling point for the independent trust company. Note, however, that the independents are not always interested in managing smaller accounts (say <500K). One reason is simply that the reputation of an independent trust company -and hence its ability to attract new business - depends, perhaps critically, on quality service. Thus a smaller account may not generate sufficient fee income to justify the telephone calls and correspondence that it takes to manage a private trust account properly.

Communications is, of course, also affected by geography. Certainly it is an advantage for the beneficiary if the trustee is close to home. But a bank, just like an individual, can 'move away' if bought out or merged with another institution, making face to face communication cumbersome. Under such circumstances, finding the 'right' lawyer to provide out of state representation in the event of a serious problem demanding timely resolution may prove very difficult indeed.

FEES AND COSTS

The creator is intimately involved in the drafting and funding of his/her trust. Hence it is understandable that a creator should feel that paying the trustee's fees is also his/her responsibility. But, of course, it is the beneficiaries rather than the creator, who will pay. Because fees can have a significant impact-both indirectly on asset allocation decisions and directly on the amount of income that will be available to the beneficiaries - it is in the creator's interest to find a fiduciary who can provide maximum investment performance at minimum cost.

Management fees are designed to compensate a trustee for acting in multiple roles - as a fiduciary, investment advisor and custodian of the assets. In a typical situation, a corporate trustee will not only take legal responsibility for proper care of the assets (fiducial function) but will also be responsible for their productive investment in an appropriate mix of equities and fixed income securities (investment function). In addition, he will provide any necessary 'mechanical' backup such as collecting the receipts (dividends, interest payments, etc.), furnishing periodic accounting statements to the income beneficiary (but not the remainderpersons) and filing local, state and federal tax returns (custodial functions). Normally, a corporate trustee will want to provide all of the above services and, in particular, will discourage the use of an outside independent investment advisor designated by the beneficiaries. The reason is simple. A trustee cannot waive his/her fiducial responsibility (except perhaps in Illinois) to make the investments 'productive' whether the actual day to day investment decisions are delegated or not. Since the trustee is legally obligated to review an outside advisor's decisions, a corporate trustee will argue that its workload remains the same and will therefore refuse to discount its management fees.

Note also that larger banks are increasingly using mutual funds in addition to - or in lieu of individualized portfolios and/or common trust funds - as investment 'vehicles' for personal trust accounts. But mutual funds have 'built-in' fees and this fact may not be reflected on the beneficiaries' statements. (Such is the case with a cash management vehicle run by the Dreyfus Fund for a number of banks including, in particular, the Bank of New York.) More typically, if the fund is an 'in-house' managed fund, the fiduciary either may apply a flat fee - say .15% - or offer a reduced management fee schedule on any assets so invested. The important consideration is that there are several different kinds of charges involved—collectively termed the 'total expense ratio'—with mutuals. In theory, these can include front or rear loads, transfer fees (from one fund to another) and/or 12b-1 fees (which provide reimbursement for the fund's distribution costs). Hence, the use of a mutual fund is contemplated, the bank's normal management fee schedule should be reduced accordingly. Since the fees charged on mutual funds are not always obvious (or even disclosed) - one reason being because they are taken partly from principal - it behooves the creator to investigate. Experience indicates that total cost to the beneficiary will likely be higher than when the trust assets are managed either as an individual account or via the bank's common trust funds even if a reduction in the bank's 'management' fees has been allowed. Further, it is also becoming apparent that some banks may be introducing mutual funds into trust accounts without the beneficiaries' consent. One bank which discloses the fact is Continental Bank of Norristown, PA whose current fee schedule reads in part " . . . and it is Continental's policy to invest in the Compass (mutual) Funds, where appropriate." Hence it is probably a good idea to insert a clause in the trust instrument allowing their use only

with the permission of the beneficiaries. In particular, banks charging a separate fee on income may still charge the same fee on mutual fund income. It should also be noted that there are uncertainties (at least in some states) as to whether the day to day management of trust assets can be legally delegated to an outside party - as it would be if other than an internally managed fund was contemplated.

A major factor that affects management fees is account size. Managerial fees are generally calculated as a percentage of principal or as percentages of both income and principal. If both types of fees are expressed as a percentage of principal (assuming, of course, equivalent income) for purposes of comparison, the percentage charged on a 'small' account (say $250K) can be three times the percentage charged on a 'large' (say $3M) account. Even though a corporate trustee will probably insist that 'smaller' accounts be managed vis-a-vis its in-house 'collective' funds, the percentage fee charged on a small trust may be too large to be economical.

Fees and other costs can consume a significant proportion of trust income. For example, consider a portfolio invested 70% in equities and 30% in fixed income currently yielding say 3.5%-4.5%. A management fee equivalent to 1.25% on assets will consume one-third or more of the available income if paid entirely from income. The alternative—to pay a portion of fees from principal—has the obvious disadvantage of eroding the earnings base and therefore reducing not only the beneficiaries' future income but also the potential value of the trust assets when finally distributed to the remainders.

Fees should always be calculated on principal and never on income and for two reasons. First, a fee based on principal will increase as the principal grows, thus providing a performance incentive to the fiduciary. Secondly, a fee based in whole or in part on income provides the wrong kind of incentive by encouraging the fiduciary to maximize income—and thus its fee. (The problem with this is that trusts that use fixed income securities do not grow as fast as their equity counterparts and thus may not be able to continue—much less enhance—the beneficiaries' standard of living in the future). Further, while principal based fees are to be preferred from the beneficiaries point of view, banks sometimes prefer income based fees. Here the reason is simply that trust fees are income to the banks and, like beneficiaries, banks prefer that their income be steady and dependable rather than erratic. Thus fees based on income (rather than principal) provide a smoother income stream to the bank because portfolio income is generally less variable than portfolio principal.

An individual may be willing to serve without compensation. And that can mean a considerable saving over a bank or other professional fiduciary whose annual management fees alone will run typically from .4% to 1.5% of the assets in addition to any additional charges for 'extraordinary services'. To illustrate, consider a trust on which the annual charge for management services is 120 'basis points' (1.2%) calculated on assets worth .5M. The actual management fee on such a trust would be $6,000 per year or $60K over a period of ten years. Since money paid in fees is not available to earn additional income for the trust (if paid from principal) or to the beneficiary for investment (if paid from income), there is an additional 'cost' of whatever additional amounts such fees might have otherwise earned. As an example, assume that management fees on a .5M trust, assumed paid in quarterly installments of $1500, could be retained instead. If reinvested quarterly at 6% in 'long' treasury bonds, the savings in fees would earn an additional $21,405 for a grand savings of $60000 + $21405 = $81405 after ten years. (We assume reinvestment of earnings and no capital gain or loss on the bond itself due to changes in interest rates.) Alternately, if the 60K in saved fees were invested in the stock market and yielded a return equivalent to the annual average return of the S & P 500 over the 1976-92 time frame (about 15%[5]), $1500 saved per quarter would grow to $134,415 after ten years. (We assume that dividends are reinvested quarterly.)

Larger trusts would obviously save more. Thus, for example, a 1M trust paying $3000 quarterly in management fees could achieve savings twice[6] those of a .5M trust or $162,810 (at 6%) vs. $268,830 (at 15%) respectfully after ten years. Expressed otherwise, a 1.2% annual fee - whether retained or invested quarterly 'outside' the trust - would increase principal by 16% (at 6%) or 27% (at 15%) after ten years.[6]

Further, if the election is made to use a compensated trustee, it is clearly worth while to bargain for the best rate. A 60 basis point (.6% or six tenths of one percent) differential in fees can add up to $40,702.50 (at 6%) or $67,207.50 (at 15%) respectfully after ten years under the same assumptions as above.

Banks, in particular, can and do charge a variety of extra fees for 'extraordinary' services, services which it considers to be beyond its 'normal' management function and may not be defined in its 'standard schedule of compensation' or fee authorization agreement. These include special fees and/or costs charged not only for the use of mutual funds in the portfolio, but for tax filings, tax letters, interim accountings, account termination (may or may not include compensation to a bank's legal counsel), brokerage transactions, principal distributions, sweeping of income and/or principal account daily balances, miscellaneous legal services (including its own legal costs if a removal and/or surcharge action is brought against the trustee) and business/property management. (Note: it is extremely important that an effort be made to get a trustee to agree to waive his rights to garnish the trust assets for his own legal expenses, particularly for those incurred in connection with defending a removal or surcharge action brought by the beneficiary).

Fiduciaries do discount their current 'standard schedule of compensation' to creators, especially if a 'large' trust of (say) 3M or more is involved or if the creator agrees

to have the assets (or a portion thereof) placed in a collective (pooled) fund rather than handled as an individually managed account. Indeed, some corporate fiduciaries offer a lower management fee if the portfolio consists meinly of fixed income securities rather than equities. Furthermore, since it is often industry practice to pay a referring professional 10% to 30% of the fees collected over the first five or more years of a trust, a trustee may be more inclined to offer a discount if not so obligated.

But discounts based only on an oral 'agreement' with the creator may not last long after the trust is 'activated' (ie. funded) unless the actual fee to be charged is fixed either by the trust instrument or by an ancillary 'fee authorization agreement'. Furthermore, creators should not be misled by any pronouncements that the bank's management fee will encompass all routine management functions. Case in point: extra fees are usual for tax filings, tax, letters and daily investment of cash balances, brokerage, services that are regularly provided with (virtually) all irrevocable trusts. (As an experiment the writer instructed the Mellon Bank a few years ago not to send its tax letter or charge a fee for same. The effort was unsuccessful. The letter arrived and the fee for same was deducted - both on schedule!)

If not fixed, the management fee will vary depending on whatever the trustee's 'standard' schedule happens to be at the moment and that generally is 'up'! Since a trustee can and will charge whatever it likes subject only to court review, it is best to practice preventative medicine by insuring that a) all charges and costs are bundled into one all inclusive fee, b) the fee and the schedule for its collection are stated either in the trust instrument (preferably) or in the fee authorization agreement and c) the instrument contains a clause prohibiting the deduction of any other fee or cost without the prior approval of the beneficiaries. Bear in mind that even though banks at one time changed fee schedules only infrequently, today the situation is quite different. Increases are now likely every 2-3 years[7] and are not necessarily announced in advance[8, 9].

If a beneficiary feels that the fees being charged are too high, there is not much that he/she can do to obtain relief. If the account is not too 'large' - say under 1M - a beneficiary, by first becoming a knowledgeable and persistent complainer, may be able to win either the bank's resignation or perhaps a discount off the standard management fee schedule of up to (say) 20%[10]. Otherwise, a beneficiary's only recourse - and one that is not always recommended - may be to petition the local Orphans Court to review the matter. In this case, the bank may employ the 'counsel of record' for its own defense and likely will deduct its legal costs from the trust corpus. On the other hand, the beneficiary will have to undergo the expense of locating and paying for seperate representation. (Note that in some instances, court review may be inappropriate if there is a state statute in place setting forth maximum permissible trustee fees rather than simply requiring same to be 'reasonable').

One last detail is the question as to whether fees will be deducted from income or principal. Although it is generally better to deduct fees from income to avoid both erosion of earnings base as well as a requirement for the trustee to maintain a cash reserve, there is no compelling reason not to leave this matter to the discretion of the beneficiaries rather than grant this additional bit of 'leverage' to the trustee(s).

CONTROL AND MEDIATION ISSUES

It is crucial that all administrative arrangements be completely defined in exquisite detail before the trust is funded. Creators can negotiate administrative terms but beneficiaries often cannot unless willing to bring a court action with its attendant costs and risk to the trust corpus. In this regard, perhaps the single most important issue is that the trust administration costs be bundled into one all-inclusive fixed fee and that fee be stated and agreed to in writing. While it is highly unlikely that a creator will be able to locate a bank willing to make such concessions (one HEIRS® member was refused by ten New York banks), an individual or independent corporate trustee might well cooperate on this matter.

A beneficiary can maintain limited control if the trust instrument requires the trustee to bill rather than deduct its fees and/or allows the beneficiaries to co-custody the trust assets, tactics which are at least possibilities with an individual trustee but long shots with a corporate trustee. Fortunately, there are still other ways to give a beneficiary a degree of leverage which may be more acceptable to a corporate trustee. For example, a well-drafted clause - ie. one that does not impose a burden of showing cause and yet avoids any possible negative tax consequences - can be included in the trust instrument so that an unsatisfactory trustee can be removed and a successor named by a majority (or unanimous) vote of the income beneficiaries. (Note that the inclusion of such a clause does not, itself, guarantee the bank's cooperation. Experience indicates that banks sometimes refuse to honor escape clauses, forcing a beneficiary into court!) Alternatively, a clause can be included requiring the beneficiaries, voting (say) once a year in some appropriate manner, to affirm the continued service of an incumbent trustee. Then, if affirmation is denied, the incumbent could be replaced from a designated list contained in the trust instrument with a minimum of embarrassment. In fact, one or more of the beneficiaries could be designated to succeed the incumbent trustee(s) after reaching an appropriate age.

Another excellent way to balance the playing field is to designate two of the beneficiaries, family members, etc. as co-trustees so that they can always outvote the corporate trustee even on matters involving trustee's fees. (If desired, one co-trustee can be designated a 'special' trustee - ie. with powers limited (say) to making investment decisions. Such a special trustee would not be able to vote on any issue beyond his/her area of responsibility as so defined by the trust instrument.) In fact, there is no reason why, under

appropriate circumstances, all of the beneficiaries—even including the remainders—who are competent and have reached their majority (the technical term is 'sui juris') should not serve jointly as co-trustees without the help of a corporate trustee[11]. (Note, however, that in some jurisdictions, a single beneficiary cannot serve as his own trustee.) Further, since remainderpersons will often outnumber the number of income beneficiaries, a creator may wish to give at least equal voice to the latter's wishes by means of a voting arrangement giving each of the income beneficiaries (say) two votes to one for each remainderperson. Further, in the event that the beneficiaries are not 'ready' to serve as trustees, a clause can always be included to allow an individual or corporate trustee to serve on a temporary basis.

An incumbent trustee will normally want a 'hold harmless' agreement from the beneficiaries if and when the trust assets are due to be distributed or transferred whenever its stewardship will not be immunized by a formal court accounting. While an incumbent trustee cannot require the beneficiaries to sign such a waiver, it is in a position to garnish the trust assets for its legal defense or termination fees, delay distribution/transfer or even liquidate the trust assets (possibly triggering capital gains taxes) rather than distribute/transfer the assets 'in kind'. Therefore, in addition to prohibiting the charging of any fee/cost not previously specified in the trust instrument, it is also important that the instrument impose a time limit for distribution/transfer of the assets in the course of a removal action or normal termination. During this time, the trustee should be prohibited from manipulating the form of the assets except with the consent of the beneficiaries.

The need for appropriate protective clauses is evidenced by a recent review of 70 trust cases litigated in New York in which only 5% were won by the beneficiaries.[3] Since every contingency cannot be anticipated, it might be useful to avoid courtroom 'solutions' by including a provision in the instrument for the non-judicial, private resolution of disputes whether among beneficiaries or between beneficiaries and trustee(s) through an alternate dispute resolution (ADR) process[12,13,14] such as Judicate[15].

INVESTMENT ISSUES

A key issue that often rules whether an individual or corporate trustee will be used is the matter of investments. The trustees will have absolute control over trust investments unless this function is shared or has been specifically delegated to a 'special trustee'. Hence it is important to recognize that the investment philosophy of a bank will likely be more conservative than that of an independent trust company or of an individual trustee and for several reasons. The investments of a corporate trustee, unlike those of an individual trustee, are subject to periodic scrutiny by state and, in the case of national banks, federal bank examiners. Indeed, while existing rules generally subject all trustees to potential civil litigation (called a 'surcharge' action) in the event that a specific investment decision 'goes south', corporate fiduciaries are held to a higher standard of care, particularly if they advertise themselves as having special qualifications. But because the examination process can make a banker's life very difficult indeed, visits from regulatory authorities are never welcome. For this reason alone, it is no wonder that corporate fiduciaries tend to prefer a conservative investment philosophy. And this may be perfectly acceptable to a creator whose objective is simply to conserve rather than enhance wealth (at least in terms of nominal dollar values). If so, the time honored Prudent Man rules can be relied upon to provide an agreeable, albeit 'trustee-friendly', regulatory standard. Hence it is understandable that banks, as public institutions—knowledgeable about the legal risks attached to fiscal mismanagement and necessarily sensitive to the negative publicity attending a removal and/or surcharge action—often will choose to embrace a conservative investment style consistent with the archaic regulatory framework within which corporate fiduciaries must operate.

Common (case) law in many (if not most) states, rather than recognize that professional money managers can and do make mistakes and that it is the performance of the portfolio that counts, nevertheless can expose a fiduciary to a surcharge action for a single miscalculation. A recent HEIRS® publication[18] discusses the chilling effect of surcharge rules on bank investment strategy-

> *Certainly, (bank) investment officers are sensitive to the absolute risk of capital loss presented by a prospective investment. And, just as certainly, an investment officer is sensitive to his personal risk pursuant to a failed investment! On the other hand, it can be argued that successful portfolio management requires the selection of investments which present the greatest expectation of reward relative to the risk of loss - i.e. investments which offer a favorable balance of potential reward vs. loss consistent with the investor's tolerance for volatility. So the question we pose is as follows. Are beneficiaries' interests being compromised by exposing the investment officer to the threat of a downstream surcharge action (and consequent reprimand or even dismissal) if one of his investment decisions should go sour? In the real world, it is argued that opportunities presenting significant potential for capital gain relative to the risk of loss may be ignored simply because the investment officer judges that the absolute risk of capital loss is sufficiently high to pose a risk to himself. To paraphrase Church and Seidel[19], this overemphasis on risk tends to put personal trust officers in the ultra-conservative class and place the portfolio at risk through lost opportunities. To make matters worse, there are few balancing carrots. Granted, a bank may enjoy the prospect of a slight*

positive increment in its fee base if an investment succeeds. And yes, banks, beneficiaries and trust officers alike are always happy to see trusts grow steadily rather than diminish. Yet, we don't know of any bank[20] that offers a direct financial incentive to an investment officer for a successful investment decision. And it also is doubtful whether income beneficiaries will ever spur their investment officers to adopt appropriate investment strategies if, in their wisdom, they continue to remain more interested in high income rather than capital gains!

Interestingly, experience indicates that beneficiaries often question a lack of activity in their accounts, sometimes complaining that it is a sign of inattention. Without addressing the issue as to whether a minimum level of activity is a hallmark of successful investing (we doubt it!), it is interesting to speculate whether such inactivity reflects a) a desire by the individual investment officer to minimize the number of investment decisions for which he will ultimately be responsible and/or b) his preference to preserve the original portfolio (the so-called inception assets) to the extent possible since these investment decisions belong (conveniently!) to the settlor. Needless to say, such "investment strategies" can hardly be said to promote good portfolio performance.

On the other hand, informed creators recognize that the trust corpus must grow in order to hedge inflation and hopefully with sufficient speed to provide wife and children (the technical term is 'issue') with an enhanced lifestyle. Creators with this point of view can avoid the restrictions posed by bank 'master lists' by seeking either an independent trust company (ie. an incorporated money management firm with trust powers) or a private individual (who might be a principal in a money management firm) possessing both good investment skills and, most importantly, an informed attitude towards the use of fixed income securities in the trust portfolio.

The allocation of assets between fixed income (ie. bonds) and equities (ie. stocks) is the single most important investment decision that will ever be made by the trustee(s) and will critically affect the total return (income plus capital gains) produced by the trust portfolio. Unfortunately, banks sometimes appear to prefer the 'balanced' portfolio to one that is heavy (say at least 85%) in equities. While boosting intermediate term income with bonds may be a convenient way to 'conceal' the high cost of corporate management (which can consume up to 30% or more of income), fixed income securities are nevertheless a mixed blessing. One reason is that the total real return on bonds - ie. after taxes, management fees, and inflation - may be non-existent or even negative. (Inflation can cause negative total returns through its depreciating effect on bond values). Another is that the total return of bonds has traditionally been a fraction of that available from equities. Further, the argument that it is worthwhile to include bonds in order to dampen portfolio volatility (the technical term for which is 'risk') is not convincing. Since trust funds are typically set up to run for many years and are not (or should not be) subject to major unplanned invasions of principal, volatility should not be a major concern. Hence we believe that fixed income securities should only be used sparingly and then only as necessary to build near term income, as a parking place for funds awaiting investment or by a highly skilled professional as an interest rate play.

It can be anticipated that a bank will want to place a 'smaller' trust - say 1M or less - in one of its common trust funds (also sometimes termed 'collective' or 'pooled' funds) rather than offer individualized management. Although beneficiaries sometimes complain about such 'treatment', there is little doubt that, generally speaking, assets placed in a collective fund will probably receive more attention than if handled as an individualized portfolio. Further, although a bank may be reluctant to disclose to beneficiaries the entire list of securities comprising a specific fund, this can work to the beneficiaries' advantage by encouraging a more aggressive investment strategy than might be permissible with an individualized portfolio. The theory behind this remarkable assertion is that the lack of visibility of the particular securities held within a common trust fund deters a beneficiary from mounting a surcharge action whenever a specific security 'goes south'. Banks may also find it in their own self interest to adopt a more aggressive investment strategy with collective funds since their performance statistics can be promoted to clients.

In fact, the American Bankers Association publishes statistics comparing the investment performance of bank funds against insurance companies, mutual funds and individual investment advisors[21]. In evaluating such data, however, it is important to remember that year to year results vary considerably not only with regard to the performance of a particular fiduciary but among money managers. Thus one bank might demonstrate excellent performance over one, two or even three years but drop to the bottom of the pack the fourth year. In this respect, it is important to seek out a fiduciary who can demonstrate a long term record - minimum five but preferably ten years - that is consistently superior. This may turn out to be such a difficult search that some will decide to settle for index funds if available at appropriate rates!

There may not be any other option open to a smaller trust other than to use a bank's collective fund because independent trust companies—at least those in the Philadelphia area—tend to impose relatively high account minimums. Indeed, collective funds have a number of interesting characteristics. For example, 'units' in such funds are not 'portable' and therefore must be cashed out if the trust is terminated or transferred. This can have the effect of discouraging transfer of the account to an alternative

fiduciary because of the 'instant' liability for capital gains taxes. Secondly, any monies placed in a collective fund may be subject to discriminatory tax treatment if the units are redeemed after only a short period. The reason is that under the accounting systems employed by many banks (and apparently at least some mutual funds as well), any tax liability resulting from sales of securities held by the fund will be allocated according to the proportion of the fund owned by each beneficiary at the time of sale rather than with respect to the period of time each beneficiary has owned (a share of) the fund. Hence a beneficiary owning his/her 'units' for a 'short' period may be liable for capital gains taxes on securities bought by the fund prior to his/her purchase of the fund. Consequently, investments in collective funds should be avoided if the trust is due to terminate or be transferred within (say) a few years.

But a creator can take advantage in three ways. Prior to purchasing shares in a fund, he/she can inquire as to whether any sales of securities are contemplated and, if so, postpone purchase until the completion of such sales. Secondly, he/she can seek out 'young' funds which will continue to be purchased on behalf of new clients as opposed to 'mature' funds whose asset base has stabilized. The reasoning is as follows. Units in a particular fund are constantly being purchased and sold on behalf of individual trust accounts. If cash inflows to the fund (resulting from purchases of fund units) balance cash outflows (reflecting redemption of fund units), then the need to liquidate fund securities does not arise. If, however, demands for cash exceeds that available from new purchases, fund securities will have to be liquidated to meet the shortfall - resulting in a possible tax liability. Hence, all else equal, a younger fund into which new money is constantly being added is a better bet from a tax viewpoint. Finally, because holding any security over the long term is an excellent strategy for reducing capital gains taxes (as well as avoiding the erosion of principal caused by the payment of taxes), it may be worthwhile to search out those funds holding the kind of equities that appear particularly appropriate for long term investment. In any event, whether these suggestions will have any merit in a particular situation will depend partially on the anticipated lifespan of the trust as well as the timing of any principal distributions that might have to be met by sale of fund units.

It is also important that a candidate trustee be sensitive to any tax issues related to management of the trust corpus. In particular, the prospective trustee should agree that any proposed changes in the 'inception' (original) assets should have the potential to enhance future total returns once the earnings base of the trust has been eroded by the payment of any capital gains taxes due. (Obviously it is easier to make changes while the trust is 'young'!)

Academic studies have demonstrated that a fully invested position is more likely to produce superior long term performance than one which maintains a cash reserve in the hope of timing the market. While it is likely that most fiduciaries would follow a 'fully invested' investment strategy anyway, it might be well to confirm the fact.

Finally, another 'investment' issue relates to the fact that the beneficiaries may need to make a loan sometime in the future. If so, borrowing from a trust is almost 'free' because the interest paid on the loan will be recycled as income to the beneficiaries with no loss of tax benefits. While experience indicates that banks are generally reluctant to loan trust capital to beneficiaries, an individual trustee or independent trust company might be more flexible than a bank in this respect. (Just be sure that an appropriate provision is included in the trust instrument!)

There is, at least in theory, no compelling need for the trustees to be 'financial experts' in view of the variety of mutual and other 'managed' funds that are available today. Indeed, management costs can be substantially reduced by the use of index or other funds available from vendors such as Vanguard[16]. For the more adventurous, financial newsletters are also available which offer constantly updated model portfolios. The Hulbert Guide to Financial Newsletters[17] currently reviews 124 such letters and has performance data over 9-12 years available on some. A few - such as the Chartist, Value Line Investment Survey, Zweig Forecast, BI Research - quite consistently and often substantially - outperform equity market averages. To take advantage of such cost effective money management, a creator need only arrange a custodial agreement between a or brokerage house and the trustees (who may, in fact, be the beneficiaries) to cover contingencies such as the transfer of administrative responsibilities should one of the trustees die or become incapacitated, etc. (For an "active" account, a bank's ability to get executions at institutional rates (4-10¢ share) may make it a more economical choice than a brokerage house).

One extremely interesting and perhaps unique variation is available from the PNC Bank in Pittsburgh. Assuming that appropriate provisions have been made in the trust instrument and that the bank has been designated a co-trustee, the creator - in conjunction with his broker or registered investment advisor - reportedly can maintain control over investments. The bank's fees for this arrangement (called 'Trust Link') are not specified in available literature but presumably would reflect the fact that the bank is essentially providing only custodial services.

INFORMATION ISSUES

Another concern relates to the unwillingness of corporate trustees to let beneficiaries participate in the investment process. Despite the fact that income beneficiaries generally have a right to material information affecting the administration of a trust, a right that in some jurisdictions extends even to remainderpersons, experience suggests that banks in particular are generally unwilling to discuss - much less document - the details of any particular investment decision or even give the beneficiary any warning

of an impending change in the portfolio. Because only an informed beneficiary can exercise oversight over the administrative process, it is important that this issue be resolved in writing prior to funding of the trust. Indeed, one advantage in letting a beneficiary serve as his/her own trustee is that a corporate trustee is under a more stringent obligation to share administrative information with a co-trustee as opposed to a beneficiary.

Further, until trustees are required to provide easily understandable statements comparing trust performance against standard indices (equity, fixed income and inflation), beneficiaries will continue to have a difficult job in evaluating the quality of the trustee's administration. Of course, a non-professional trustee such as a friend, relative, etc., might not be able or even willing to provide periodic accountings despite possible state regulations requiring same. Hence, if an individual is to be responsible for investments, it might be advisable that the trust instrument direct that he/she invest with an appropriate mutual fund or designated professional to assure availability of such reports. It is also suggested that the creator ask the prospective corporate trustee to provide sample accounting statements - both for income/principal transactions and for investments - and then review same with his/her beneficiaries in order to be sure that the information needed to flag inadequate performance is available in an easily understandable form. In addition, a trustee who will be responsible for investments should be required to furnish the beneficiaries with copies of the annual federal fiduciary return.

LAWYERS AS TRUSTEES

One topic discussed at the recent ABA forum[3] on removal standards was lawyers who serve as trustees. In defense of his prediction that lawyers will be used more frequently as trustees in the future, one member of the panel, a preeminent trust/estate authority, stated that "lawyers in general provide better service and are a lot smarter than the people who handle . . . bank trust accounts." He went on to point out, however, that " . . . when you have lawyers (as) fiduciaries, you then also have the problem that . . . (the provisions of the trust instrument) . . . will (ordinarily) be drafted by the person who is going to be the trustee. You therefore have a new layer of conflict of interest...." From the point of view of the beneficiary who may be faced with removing a lawyer as trustee, we think there are also two other negatives to using a lawyer as trustee. First, a lawyer can represent himself while the beneficiary must hire counsel 'at retail' in order to prosecute a removal or surcharge action. Secondly, it may be difficult to locate any counsel at all if there is any truth to the adage that lawyers don't like to go 'one on one' against each other!

FUTURE TRENDS

Anecdotal reports plus IRS and Federal reserve data suggest that creators continue to prefer individual as opposed to corporate trustees by a wide margin. Nevertheless, many creators will continue to opt for corporate management. Indeed, if the trust management game was once limited to banks, today creators are fortunate in being able to choose among many new players including the likes of Merrill Lynch, Shearson, Paine-Webber, Alex Brown, T. Rowe Price and, most recently, Prudential as well as an ever increasing number of private trust companies including Vanguard. Needless to say, it is the newer players that may be willing to offer concessions not available from traditional providers such as the banks. By way of illustration, membership in the Chicago based Association of Independent Trust Companies (AITCO) now counts about 60 members with one examiner reporting 18 current applications for trust powers in Indiana alone! [To learn if an AITCO member resides in your area, call (312) 644-6610. The names of independent trust companies located in Pennsylvania - 20 in all - are available from HEIRS® or by calling Don Lightner at the Pennsylvania Department of Banking - at (717) 787-2571.] The profound changes now taking place in the trust industry are perhaps best illustrated by a quotation from the June 1990 trade publication Bankers Monthly - to wit " . . . as of 1990, the overwhelming majority of bank customers opt for non-banks when it comes to trust management . . . and banks have lost fresh business to mutual fund companies (who) . . . have made tremendous strides in assets under management in the 1980's" (underlining supplied).

---

[1] The Tools and Techniques of Estate Planning, Leimberg, Stephen R. et al, 8th Edition, The National Underwriter Co., 5050 Gest Street, Cincinnati, OH 45203, is an excellent book. Another good introductory reference is Trusts - A Guide to Trust Options for Avoiding Probate and Taxes, available from HALT, Publications Dept., 1319 F Street N.W., Suite 300, Washington, DC 20005; Ph. (202) 347-9600.

[2] Neafie's Estate, 199 Pa 307, 312 (1901)

[3] Do We Need a New Standard for Removal of Trustees and Termination of Trusts?, American Bar Association, Section of Real Property, Probate and Trust Law, NY, Plaza Hotel, August 10, 1993

[4] A Survey of Trustors and Trust Beneficiaries, Smith, Standish H., HEIRS®, June 10, 1992.

[5] Data from Stocks, Bonds, Bills and Inflation, 1993 Yearbook, pg 40, Ibbotson Associates, Chicago, IL.

[6] Note, however, that fees typically scale downward as a trust increases in size. Thus a bank charging 1.2% on a $500K trust would charge less - perhaps 1% on a 1M trust. For this reason, the savings on a larger trust would not necessarily be proportional to those on a smaller trust.

[7] Trust Department Management Manual, Mennis, Edmund A., Scheshunoff Information Services, Inc., Austin, TX copyright 1991, p 1-25

[8] Bank Acquired by B of A Raised Fees Improperly, Kenneth Howe, San Francisco Chronicle, March 24, 1993.

[9] B of A Hit With Suit over Fees, Kenneth Howe, San Francisco Chronicle (no date available)

[10] Strategies for Managing (or Replacing) A Corporate Trustee,

Smith, Standish H., The HEIRS® Organization, copyright 1993, pp.7-9.

[11] Price on Contemporary Estate Planning, Price, John R., Little, Brown and Company, Boston, MA 1992, pp.909-910.

[12] Have Business Card, Will Mediate, Business Week, December 7, 1992, p.125.

[13] Got a Beef? Call in a Peacemaker, Business Week, September 23, 1991, pp 122-3.

[14] Contempt of Court, Solomon, Stephen D., INC., October, 1989, pp. 107-114

[15] Judicate, the National Private Court System, 1608 Walnut Street, Suite 1200, Philadelphia, PA 19103-5406 Call (800) 631-9900.

[16] For information on index and other funds offered by Vanguard, write The Vanguard Group of Investment Companies, Vanguard Financial Center, P.O. Box 2600, Valley Forge, PA 19462 or call its Investor Information Department at (800) 662-7447. (For information on possible future offerings re: irrevocable trusts, call Sue Armas at (215) 669-6452.

[17] Hulbert Guide to Financial Newsletters, 5th Edition, 1993, Dearborn Financial Publishing, Inc.

[18] Suggested Federal Reforms in the Administration of Personal Trusts, March 1, 1993, Smith, Standish H., pp.12-13

[19] Church, Jr., J.W. and Seidel, Richard B., Rearming the Prudent Man, Trusts and Estates, September 1986, p.25.

[20] One possible exception is US Trust which is reported to make incentive payments to its investment officers

[21] Equity Performance 1983-1992 (for) Banks vs. Other Managers, American Bankers Association, 1120 Connecticut Avenue, N.W., Washington, DC 20036, March 1993.

SIGNS OF PROGRESS

RE: TRUST LEGAL EXPENSES

(1) We note that the Mellon Bank's current trust management fee schedule has this to say under "Additional Charges".

> "Conditions sometimes exist, however, which require more than normal attention and service. These may involve... *assisting counsel in connection with litigation* . . . ."

This is the first time that it has come to the writer's attention that a bank has been willing to disclose that there may be legal costs associated with administering a trust.

(2) An article in the Wall Street Journal for June 23, 1993 concerned 'double dipping' by trust/estate lawyers when serving in the joint role of executor and counsel of an estate. The article noted that while the California legislature was expected to make this practice illegal without prior court approval, a similar proposal in New York state encountered significant resistance. The article went on to state that Gene Erbein, a staff member on the California Assembly's judicial committee, believes that ". . . some of these (lawyers) are real predators . . . . and that . . . . .the bill would discourage lawyers form naming themselves as the exclusive trustee of a trust." The article also quoted William Zabel, an estate lawyer with practices in New York and Florida, as saying that ". . . .negotiation is the wisest course for people worried about legal and executor fees (even though). . . . people get very inhibited when negotiating legal fees in the death situation." (brackets supplied).

Comment: Similarly, trust fee agreements are pressed on settlors or their beneficiaries at a time when personal crisis precludes consideration of possible alternatives. Note, however, that a trust fee agreement executed by a beneficiary can sometimes be rescinded at least in Pennsylvania.

RE: PORTABILITY

In a survey conducted in August of 1991, the major Philadelphia banks and independent trust companies were asked whether they would resign in favor of an alternate fiduciary if requested. At the time, all of the independent trust companies indicated that they would do so while all of the banks said they would need to examine the 'individual circumstances' of each case—indicating at least the possibility of a contest. In this connection, we are in receipt of an interesting letter from one John P. Pelcheck who does trust 'development' work for the Lehigh Valley Bank of Bethlehem, PA. We quote Mr. Pelcheck in part—

> "The HEIRS® organization is promoting legislation to allow beneficiaries of Pennsylvania trusts to have cost effective means of replacing an unsatisfactory trustee. The concept is a good one; any trustee not doing their job should be replaced."

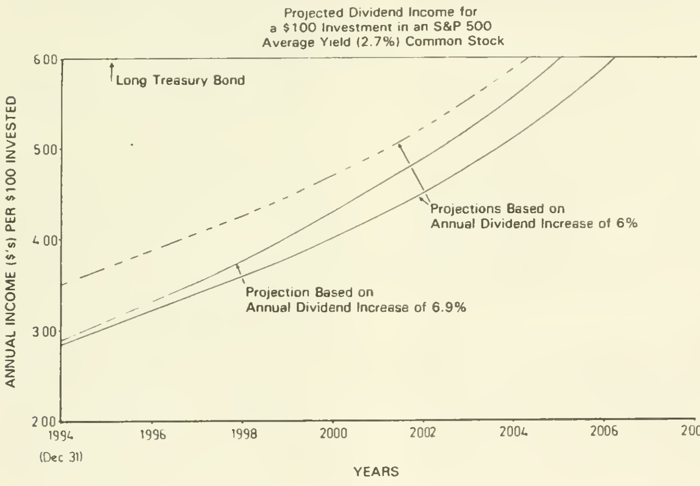
While Mr. Pelcheck does not go so far as to state that his bank would step aside on a 'no questions asked' basis if requested to do so, his letter does represent the very first written endorsement of our activities by a bank!

(If you have requested the Lehigh Bank to step aside as the corporate trustee of your trust, please let us know how you fared).

GOODBYE BONDS - HELLO EQUITIES!

It is said that only an independent corporate trustee can balance income beneficiaries' demands for maximum income (via bonds) versus the demands of remainderpersons for growth (via common stocks). What the argument ignores is the fact that, despite any advantage in using bonds to enhance intermediate term income, all beneficiaries benefit over the longer term by a portfolio that uses bonds sparingly. The fact that is less appreciated is that the use of bonds instead of stocks in a portfolio essentially trades higher income for capital gains but only with a significant loss in total return (income plus capital gains). And despite income beneficiaries' oft' heard contention that capital gains belong to the remainderpersons, only capital gains can counterbalance the erosive effects of inflation and augment principal in the event that any beneficiary has need of a future principle distribution.

The difference in income produced by bonds vs. stocks over the intermediate term can be profound. For example, suppose we have $100 to 'invest' in our choice of a long government bond yielding 6% or an 'average' S&P common stock currently yielding 2.7%. While the annual interest received from the bond will always remain fixed, the dividend stream from the common stock will, if history is any guide, increase each year until, at some point, the yield on both will be the same. But how long will that take? Though no one knows how fast the economy - and thus dividends - will grow in the future, perhaps it is not unreasonable to assume that the dividend growth rate prevailing over the last ten years (6% annual average)[1,2] may be indicative of the future. If so, the graph shows that it will take 13 years for the current yield on a $100 common stock investment ($2.70) to catch up to the annual yield on a 6% long treasury bond ($6.00). (It is to be understood, of course, that there is no such thing as an 'average' yield S & P 500 stock but that we are using same as a proxy for a hypothetical S & P stock portfolio with an average yield of 2.7%. Similarly, the impossibility (impracticality?) of investing a sum as small as $100 in either one stock or a long government bond is also clear.)



Of course, this projection will change if a different assumption is made concerning future dividend growth or if a higher (lower) yield stock is 'purchased'. For example, if a 3.7% (instead of a 2.7%) yield common stock were assumed, the graph indicates that we might expect (again assuming a 6% dividend growth rate) that the point of equivalent yield might be reached in only 11 years. (While it might appear that a stock with a higher yield can catch up more quickly to its bond counterpart than a lower yielding stock, there is a catch. Higher yielding stocks as, for example, those of

companies comprising the D-J index or the utilities, tend to demonstrate lower dividend growth than the lower yielding stocks issued by younger, lower 'cap' companies.) It is also obvious from the graph that a common stock of given yield can close the gap more quickly on a lower as opposed to a higher yield bond. The graph does demonstrate one interesting point - that the increase in dividends from year to year is not expected to be linear but exponentially positive. In other words, annual dividend increases in dollar terms can be anticipated to accelerate from year to year so that the annual differential in income not only becomes less and less as yield equivalency is approached but gets greater and greater in favor of common stocks after equivalency! Despite the fact that a stock yielding 2.7% today with a projected 6% dividend growth rate will deliver about $21.50 (27%) less total income over the years prior to equivalence ($56.50 for the stock vs. $78 for the bond), the decrement is made up in an estimated four years following equivalence. (The difference in inflation adjusted dollars is slightly less - about $20.83.)[3]

Our assumption of a 6% growth rate may be conservative. We could assume, alternatively, that dividends will expand at the same annual rate as an average S & P 500 stock did over the 1927-93 period (6.9%). If so, the graph illustrates that equivalence would be reached in something over 11 years.

Historical yield data also suggest that higher growth rates may occur in the future than have been experienced in recent times. First, dividend increases in 1992 on an average S & P 500 stock were very low (3%)[4] compared with either the last ten years (average 6%) or the last 67 years (average 6.9%)[1,2]. Consider also the fact that annual common stock yields (2.7%) are presently at historic lows whether compared to the S & P 500 average annual yield over the 1984-93 time period (3.8%) or the 1926-93 time period (4.7%)[1] In addition, the current 2.7% rate is also low compared to the quarter by quarter yields that prevailed throughout the 1945-93 period.[1] (Quarterly data is not readily available prior to 1945.) Common stock yields also appear to be at or near the bottom of (what appears to be) a 25-30 year cycle[1].

What might an increase in yields portend for dividends? Increases in yields can occur only if a) dividends rise but stock prices remain steady (or fall), b) stock prices fall but dividends remain steady (or increase) or c) dividends increase (proportionally) faster than stock prices. Since both dividends and common stock prices typically have risen almost every year since World War II, it seems more reasonable to assert that a rise in yields would be due to (c). And, as a matter of timing, an increase in dividends would necessarily precede rather than follow an increase in common stock prices because dividends (in part) drive common stock prices and not vice-versa!

Our thesis that dividends will increase is challenged by the fact that the number of companies reporting quarter to quarter dividend increases has been trending down over the past ten years - from 2400 in 1983 to about 1250 through October of 1993, providing perhaps part of the explanation for current low yields. Nevertheless, the number of companies reporting quarter to quarter decreases is currently well below any year since 1983. In fact, the ratio of increases to decreases was 19-1 and 7-1 respectively for September and October 1993 compared to an historical average of 6 to 1.[4]

Low inflation and interest rates tend to promote economic growth and (consequently) dividends. Because inflation tends to drive investors out of longer term bonds and into equities (the latter provide a better hedge against inflation), higher inflation tends to increase common stock prices despite having a generally depressive effect on the economy (read dividends). But here's the point. The current inflation rate, while close to the average for the 1926-93 time frame (3.1%), is nonetheless very low compared to rates prevailing since 1965[1]. In fact, the 1992 rate of 2.9% was lower than for any other year since 1965 (save for one year) and is expected to be 3% through 1994.[1] Further, if there is any trend at all to be discerned about near term inflation rates from graphical data, it is that rates are headed downward rather than upward.[1] Interest rates are also currently at or near historic lows although there is evidence that rates may have bottomed if recent declines in utility prices are any indication.[5]

Another important prognosticator of future economic growth is the difference in yields available from long term vs. short term governments (also called the 'yield curve'). To quote professors Bodie, Kane and Marcus, " . . . the shape of the yield curve reflects investors expectations about inflation . . . (and the fact that they demand) . . . bigger long term yields on their money . . . when they expect higher future inflation. A steeply shaped curve (such as currently prevails) . . . suggests that monetary policy is relatively loose . . . (implying) . . . that future output will rise at least in the short term . . ." They go on to relate that ". . . a recent study concludes that the slope of the yield curve has been one of the best predictors of changes in (economic) activity between a year and 18 months ahead. It's forecasting record is better than that of (its) three rivals: the index of leading indicators, real short-term interest rates and consensus GNP forecasts[6]." (Brackets supplied) Further, according to Greg Jones, an economist at MMS International, a financial information concern, "the steep yield curve is telling us that we are near the end of a recession and the beginning of a recovery[7]." Finally, we note that investors are certainly supplying capital to emerging companies if the current boom in the IPO (initial public offering) market is any indication. Consistent with this bullish thesis are recent upticks in leading indicators, factory orders and construction,[8] the biggest one-month drop in unemployment in ten years[9] and a continued rise in personal consumer spending[10].

Despite the fact that high long interest rates[11] indicate that investors are concerned about inflation, what is

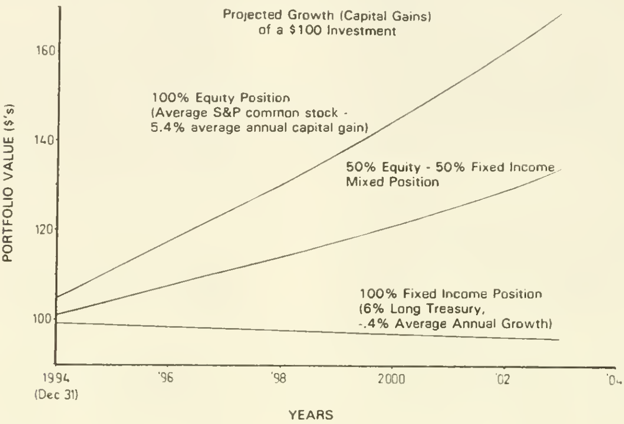
important is that the economy pick-up before higher inflation rates kick-in. The bet (and it is a bet and not a fact) is that currently idle resources such as a workforce that is partially unemployed (or underemployed), excess manufacturing capacity/office space, etc. are adequate to supply a strengthening economy before increasing competition for such resources increases not only the costs of doing business but also interest rates (because it takes money - often borrowed money - to buy those resources! We would like to believe, therefore , that a near term expansion of economic activity is more likely than a continuance of the status quo (or, indeed, a contraction), hopefully signifying that dividends may accelerate over the near term. And if this be so, we might expect that future common stock yields will match bond yields sooner than have been depicted on the graph.

So far we have focused on the income side (dividends, interest) of securities. But capital gains are also important because they - at least in the case of common stocks - represent not only an expanded earnings base but provide the additional capital for future principal distributions. Holders of common stocks benefit from higher corporate earnings (and consequently) higher dividends as well as the higher common stock prices (capital gains) produced by a growing economy. But an increase in the return of a bond can only come from an increase in the price of the bond. (This will occur when a change in market conditions allows new issuers of bonds to pay a lower interest rate. In this event, the fixed (coupon) rate on existing bonds makes such bonds more valuable and vice versa. Equivalently, market conditions may allow bond holders to demand a higher price, thus reducing the effective yield to the purchaser.) In any event, the price of a bond won't increase unless interest rates fall.[12] However, a reduction in interest rates does not seem likely over the intermediate term. Rates are now at or near historic lows and there appears to be only limited prospects for further reductions in inflation (which would otherwise reduce long term rates even further). Hence, the era of fat capital gains that prevailed throughout the 1980's - a period during which rates descended from 14-15% levels on long and intermediate governments to present single digit levels[1] - appears to be over for the time being. Long term statistics are also dismal. Long term government bonds over the 1926-93 period actually showed an average annual capital loss of .4% while intermediate term governments gained only .3%[1]. The important point is that if interest rates start to rise say over the next few years - whether because of renewed inflation or supply/demand factors associated with a recovering economy - prices of longer term bonds will decline, handing their owners unexpected capital losses. Indeed, there is some recent evidence that rates have already rounded the corner if recent upticks in long and short rates are any indication. (The amount of any decline will, of course, be tempered by the maturity date of the bond since the holder is guaranteed par (face) value at maturity. Hence shorter maturities present less 'interest rate risk' than longer maturities.)

There are some other reasons why bonds are not currently a worthwhile investment medium for intermediate term investors. Suppose we again take our 6% treasury bond and see what the inflation adjusted 'real' yield (as opposed to the 'nominal' yield in dollars) would be after one year. On the one hand, we certainly do have $6.00 cash in hand at year's end, income that is virtually guaranteed by the taxing power of the government. On the other hand, the government will take at least 28% back as taxes (and perhaps more depending on the holder's marginal bracket) so $6.00 quickly becomes $4.32. Then, of course, there is the annual 1% bank management fee which, calculated on $100 worth of principle, reduces our return by another dollar to $3.32. But the big hit comes when we consider not just the possible negative effects of rising interest rates but the impact of inflation on the value of our $100 bond. At current inflation levels of 3%, $100 will buy just $97 worth of goods by the end of 1994 (Equivalently, a dollar of interest income today buys about 97¢ worth of goods one year later.) So despite the fact that we got to spend $6.00, $3.00 of that $6.00 was really squeezed from the value of the bond - a 'return of principal' which the income beneficiary can spend once but which will never be replaced to serve the future financial needs of either the income beneficiary or remainderpersons. Hence the real return on our $100 bond is not $6.00 at all but just 32¢. In short, bonds provide a perfectly legal way to liquidate a trust whether by rising interest rates, inflation or corporate bankruptcy. (Interestingly there are no specific strictures governing their use under Prudent Man rules!) Of course, one can spring for a $4.64 real return by opting for 12% corporates (so called 'junk' bonds) if the additional yield is worth incurring some risk of default.

The alternative is to invest in stocks. Granted, equity prices nor yields never sit still. During the post World War II years, total returns on common stocks sometimes retrenched for as long as four-five years before resuming their upward course. But it is also just as true that there have been only 13 years since 1942 that S & P 500 common stock prices on average have fallen. In every other year, they rose! Nor has there has ever been a year since 1926 that the S & P 500 average yield has been lower than the 3% registered in 1992!

The graph below illustrates the growth (capital gains) that might be expected if $100 were invested in a) a long 6% treasury bond, b) an 'average' S & P 500 stock or c) a 50-50 mixture of each. Projections are based on growth data from the 1926-92 period.



In closing, we present the total returns that the six major classes of financial assets have shown over the 1926-93 time period. ('Total' and 'income' returns assume reinvestment of interest/dividend payments)[1]. Goodbye bonds and hello equities!

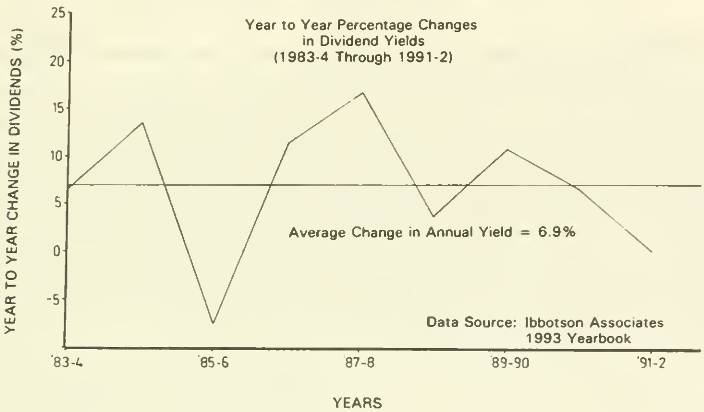
Annual Returns in % (1926-92)
( ) - Inflation Adjusted

Asset Class	Income	Capital Gains	Total
Common Stock (S&P 500) - currently yielding 2.7%	4 7	7.4	12.4 (9 0)
Small company stocks (NYSE et al)	-	-	17.6 (14 0)
Long term corporate bonds (Salomon Bros index) currently yielding 6.5%	-	-	5.8 (2.7)
Long term government bonds (approx 20 year maturity)	5 1	-01	5 2 (2.1)
Intermediate term (approx 5 year maturity)	4 7	4	5.3 (2 2)
US Treasury bills (approx one month maturity)	-	-	3 7 (6)

Source Ibbotson Associates

[1] Data derived from Stocks, Bonds, Bills and Inflation, SBBI 1993 Yearbook, Market Results for 1926-1992, Ibbotson Associates, Chicago, IL 1993

[2] The average annual percentage increase in dividends was calculated by summing the annual percentage increases for an average S & P 500 stock. Projecting future dividend growth rates using such an average is only justified if the annual percentage changes themselves show no discernable trend. As a partial check, year to year percentage changes in dividend yields from 1983-4 through 1991-92 were plotted. The results shown below do not appear indicative of any (recent) upward or downward trend.



[3] Assuming a 3% annual inflation rate for the next 13 years, one dollar of income at the end of the first year is worth 97¢ (3¢ loss) vs. 68¢ (32¢ loss) at the end of the 13th year or about 3¢ per year per dollar. For the bond, the loss is 3¢ x 13 years x $6 = $2.34. Since the yield on the stock increases from year to year, we first estimate its average yield. That can be calculated as follows: ($2.70 + $6.00)/2 = $4.35. Hence the loss on the stock is estimated to be 3¢ x 13 years x $4.35 = $1.70. Thus the difference in inflation adjusted dollars is estimated to be $2.34 - $1.70 = 64¢

[4] Dividends Review, Hardy, Eric S., Forbes, November 22, 1993, p 192

[5] Two Dow Measurements Taking a Familiar Course, Norris, Floyd, New York Times, November 7, 1993, p.13.

[6] Investments, Bodie, Zvi, Kane, Alex and Marcus, Alan J; Irwin, Homewood, IL 1993, p.524

[7] Ibid p.461.

[8] Business Week, November 8, 1993, p.29

[9] Who Needs a Boom?, Church, George J., Time Magazine, December 13, 1993, p.33

[10] Consumers Starting to Spend, Uchitelle, Louis, New York Times, November 22, 1993, p. D1

[11] They would be even higher if the treasury wasn't busy reducing the carrying costs of the deficit by refunding long term debt with shorter maturities!

[12] This is not quite true because the price of a bond bought at a discount will rise to its par (face) value as the bond approaches maturity

MUTUAL FUNDS MAY INCREASE TRUST ADMINISTRATION COSTS

Open letter from HEIRS® to Eugene Ludwig,
Controller of the Currency
Office of the Controller of the Currency (OCC)
Washington, D.C.

Dear Mr. Ludwig,

I am writing to you at the suggestion of Dean Miller and on behalf of HEIRS®, a national organization of beneficiaries who have cause to complain about bank management of their irrevocable trusts.

The introduction of mutual funds into irrevocable trust accounts managed by corporate fiduciaries threatens to increase administration costs to beneficiaries. As you are aware, banks have traditionally maintained common trust funds (CTF's) as investment vehicles for smaller accounts. And beneficiaries often favor CTF's because they receive a fee discount while getting 100% yield on each dollar invested with no erosion of principal. But the fact that certain fees/costs associated with mutuals are 'hidden' makes it difficult for a beneficiary to assess the actual costs of management. Further, some banks may be inclined to use mutuals in lieu of individually managed accounts or CTF's as a way of increasing their return. (In particular, mutuals offer a convenient strategy for bypassing fee limits sometimes associated with older trusts.) Other banks might have different reasons for embracing mutuals. For example, trust funds can provide the built-in customer base sometimes needed by a bank to launch a mutual fund operation. In addition, development officers can anticipate enhanced acceptance of mutuals by trust creators and beneficiaries alike not only because the product is familiar but because a portion of the bank's fees are taken at the fund level and hence are not obvious to the beneficiary. Banks may also anticipate higher profits through reduced investment management costs and the additional revenues to be derived from marketing 'in-house' managed mutuals to the general public. But wherever the bank's self interest might lie, it is difficult to understand how mutuals— as opposed to traditional investment techniques - can be rationalized as better able to meet the "objectives of a trust." Certainly their use was never contemplated even by creators whose trusts are of recent origin. And, as will be demonstrated presently, there do not appear to be any definitive advantages - performance, cost or otherwise - of mutuals to beneficiaries.

Two examples will suffice to illustrate the different approaches that banks might follow. In 1989, the Premier Bank of Baton Rouge, Louisiana was one of the first banks in the country to convert its collective funds to mutuals. According to spokeswoman Charlotte Ray, Premier not only fully disclosed to its clients the costs involved but offered each the opportunity to refuse conversion - in which case the option of an individually managed account was offered if the account was sufficiently large (eg. >$50,000). (While 90% of Premier's trust beneficiaries reportedly acquiesced, those with small accounts that did not cooperate were apparently convinced to go along although perhaps not willingly.) Most interesting is the fact that (reportedly) no client today is paying more in fees following conversion than he/she would have paid if their funds had continued to be managed individually or vis-a-vis one of the bank's collective funds. In Premier's case, actual management of the trust assets was not altered by the conversion; only the legal framework changed.

On the other hand, the Continental Bank of Norristown, PA has a different approach. In Continental's fee schedule, it is disclosed that a) mutuals are an 'optional' investment vehicle offered to the creator, b) the bank's management fees will be reduced by 50% on any monies so invested, and c) (to quote from its fee schedule) " . . . (the) policy (of the bank is) to invest (personal trust assets) in the Compass (mutual) funds where appropriate" (underlining and brackets supplied). With Continental, the question as to whether the final cost to the beneficiary will be higher or lower than if the trust corpus was individually managed depends on the particular mutual fund(s) chosen. For example, management fees on a 1M trust are discounted 47.5 basis points if invested in a mutual fund rather than being handled as an individual portfolio. Thus if an international fixed income mutual is selected at 130 basis points, the cost differential will be 130 - 47.5 basis points for a net increase of 82.5 basis points. If a balanced equity fund at 100 basis points is selected instead, the differential cost is less; 100 - 47.5 basis points or 52.5 basis points. What is unfortunate for the beneficiary is that of seven mutual funds offered by Continental, none is available at less than 87 basis points. Hence it seems reasonable to conclude that Continental's trust beneficiaries are (or will be) paying more for personal trust management vis-a-vis mutual funds than in prior times when mutual funds were not 'offered'.

Of course, any bank can reasonably argue that mutuals offer advantages over in-house collective funds - to wit portability, daily advertising of share prices, and (in theory) more choices for allocating assets. In addition, mutual finds (but not collective funds) can serve as collateral for loans in some jurisdictions. Some banks would also argue that mutual funds are an attractive option because they offer improved performance. If so, then it would appear that the burden of proof rests with them to show that investment performance can be expected to compare favorably with that available from other vendors or at least vis-a-vis standard indices. Unfortunately, this would appear to be a difficult thesis based on data from an American Bankers Association study published in March 1993[1]. This study compared 217 bank pooled funds, 73 insurance company 'separate and variable'

accounts, 577 mutual funds (having an objective of growth or growth and income) and 622 investment advisors with combined assets under management of 1.2 trillion. The results, in part, are presented below without comment.

	FIXED INCOME ANNUALIZED RATES OF RETURN FOR PERIODS ENDED 12/31/92			EQUITY ANNUALIZED RATES OF RETURN FOR PERIODS ENDED 12/31/92		
	3 YRS	5 YRS	10 YRS	3 YRS	5 YRS	10 YRS
Insurance Cos.	10.2	10.6	11.3	10.3	14.9	15.4
Banks	9.8	10.0	10.6	11.3	15.7	15.6
Investment Advis	n/a	n/a	n/a	11.9	16.3	15.3
Mutual Funds	9.4	9.0	n/a	10.0	14.0	13.5
Market Index	10.7	10.9	11.7	10.8	15.8	16.1

[1]Source: Equity Performance 1983-1992; Banks vs. Other Managers, American Bankers Association, Washington, D.C., March 1993.

Dean Miller, Senior Trust Regulator for the Office of the Controller of the Currency (OCC), stated recently to the writer that banks have authority to place internally managed mutual funds in personal trust accounts subject only to the provisions of local (state) law, the trust instrument, court order or pursuant to other enabling authority. Further, Miller has indicated that some - but not all - states require a bank to reduce its management fee if mutuals are used in personal trust accounts. He also has indicated that this is not a matter that can be addressed by OCC absent enabling legislation. (The position of OCC on the issue is further described in OCC Circular 274.)

It is hoped that this brief discussion may serve to spur appropriate regulatory and congressional action requiring (at minimum) that mutual management and other fees be fully disclosed and subject to the approval of the beneficiaries. Forcing trust beneficiaries to pay higher fees via mutuals is yet one more example of the urgent need to implement rules not only designed to improve disclosure but to allow beneficiaries cost effective means (eg. without having to show cause) of moving their trusts to an alternate fiduciary - whether corporate or individual. It is believed that portability would not only provide a much needed check on constantly rising corporate trust management fees but would serve to reduce the myriad complaints being voiced by beneficiaries across the country over bank management of irrevocable trusts.

I would appreciate your earliest attention to this matter.

Yours truly,

Standish H. Smith

FOUR OTHER LETTERS OF INTEREST

Letter 1

Harrison Gardner, Esq. to Professor John H. Langbein, Esq.

Harrison Gardner is a trust-estate lawyer practicing in New Jersey. He also happens to be a trustee as well as a beneficiary of a trust managed by the State Street Bank and Trust Company of Boston, Massachusetts. John Langbein is the Chancellor Kent Professor of law and legal history at Yale University. Professor Langbein chairs the Uniform State Commission's division of probate and trust and is a preeminent authority on trust/estate law in the United States. Professor Langbein was also a panelist at the recent American Bar Association symposium investigating whether a new standard is needed for the removal of trustees and the termination of trusts. Mr. Gardner takes objection to Professor Langbein's published views in a recent letter which we quote in its entirety.

Dear Professor Langbein: *November 16, 1993*

Recently you were quoted in the press as having said - "It's a fallacy to say it's your money when you are the beneficiary of a trust. It's the settlor's money. The settlor imposed the choice of trustees and he made a judgment that you are going to do business with whichever trustee as opposed to the one that you want to go to."

I hope you were misquoted and this does not reflect your view. As an attorney, trust beneficiary and family trustee, I take exception if it is. This is a consumer oriented society and the consumer (i.e. beneficiary) should be entitled to demand of the trustee some reasonable standard. You will find if you care to examine the 'Heirs' material that trust beneficiaries have been very poorly served with inferior investment performence and higher and higher fees. This is certainly been the case with my family. Why you, as a professor of law, would take a position that corresponds exactly to the position of the American Bankers Association I cannot understand. I think the best thing that could happen would be to make trusts 'portable' so that if there was beneficiary dissatisfaction objectively judged, another trustee could be selected that might better serve. Let's introduce competition. Choice of service is available to an estate beneficiary if he receives his inheritance outright. Why should a trust beneficiary be any worse off?

To say that my grandfather set up a trust for the benefit of the State Street Bank and Trust Company rather than for his grandchildren is ridiculous. If he were with us, he would be the first to join in our protests. We have an uphill, expensive fight as beneficiaries. I would hope you would join us, not the opposition. I would be curious to know if you are yourself a trust beneficiary.

Yours truly,

Harrison Gardner

If you have a viewpoint on this matter, you are invited to express same in writing.

Contact: John H. Langbein, Esq., c/o Yale Law School
401-A Yale Station, 127 Wall Street, New Haven, CT 06520

Harrison Gardner Esq., c/o Budd and Gardner
#2 Shunpike Road, Madison, NJ 07940 (tele. (201) 822-3778

Letter 2

An HEIRS® member to the Continental Bank of Norristown (Excerpt)

On July 1, 1993 (at the end of the second quarter), Continental changed their compensation structure to levy compensation on trust asset value only, and to eliminate any compensation on income. This resulted in about a 12% increase in fees (to us). However, in the third quarter statement, Continental not only charged compensation on asset value, but in addition charged compensation on income and charged sweep fees too. When I called this to their attention they said they would credit my trust, but they offered no apology or admitted any mistake. I have a sneaky suspicion that if I had not picked up the error, it would have remained undetected to my disadvantage. (Brackets and underlining added. Name of beneficiary deleted by request.)

Letter 3

Kent Youngberg to HEIRS®

(Mr. Youngberg is serving as the 'class representative' in a class action suit against the Bank of America (B of A) currently being litigated by Richard Greenfield and Associates. The same law firm is also representing Mr. Youngberg in an individual suit against B of A.)

Dear HEIRS®

Discovery: It all started very innocently. I am an income beneficiary of a generation skipping trust. I did not anticipate "following" the trust until after my parents passed away.

Several of the trust assets were having problems. Response from B of A was vague. I asked, prodded, and became frustrated. B of A clearly did not want client's questions. B of A would proclaim (that) "we are investment professionals". I would say "I am a Civil Engineer (and) you are not doing your homework".

I had 5 trust officers in as many years. Each trust officer had less experience than the last. I was educating the trust officers on the account. This was no professional financial analysis with numbers - merely "lunch" and hand holding.

Plan: Get an experienced attorney who has removed a trustee. The attorney (that was) recommended (suggested) staying with the existing bank and "working things out". (While this might be) . . . . the most cost effective approach, I decided to have none of that. I had interviewed and found a replacement trustee willing to take control of the account.

I had also read an article in Business Week about the organization called HEIRS. I educated myself and gained confidence.

Action: Take B of A to court. Twist and turns, court delays, and stalling from B of A. On court day, B of A did not even show up. B of A "bluffed right up to the court room steps."

B of A also refunded the trust account for several tens of thousands of dollars. This was to cover overcharging of fees back to 1975, when Security Pacific National Bank held the account. B of A's fourth quarter stock report shows they are retaining millions of dollars for this purpose.

Summary: The old banker adage is 3/6/3; give 3% on money, charge 6% for money, and quit for golf at 3:00. You must watch (your) trust investments (and) monitor the fees. Are the banks performing financial analysis or simply running a monthly accounting? You must take control of the trust and (your) financial future. (Brackets and minor editing supplied)

Yours,

Kent Youngberg

Letter 4

Standish Smith to the Mellon Bank and Vice Versa

The writer occasionally tends to his own knitting and, in this connection, recently 'discovered' that the portfolio of a 'very close acquaintance' was 75% in equities and 25% in bonds. Because of a conviction that bond prices are more apt to head south than north while interest rates take an opposite course, he requested that the instant portfolio manager (Mellon Bank) make an appropriate reallocation of resources. After all, it was argued, the income flow was more than necessary to sustain a comfortable lifestyle and wouldn't a more growth oriented portfolio eventually benefit both the income beneficiary and the remainders?

Here are excerpts from the series of letters that ensued between the writer and the bank over the course of two months terminating September 13, 1993.

From the writer to the bank: Dateline: July 1, 1993

" . . . the fact that interest rates are at or approaching historic lows . . . suggests that a move out of fixed income funds would be particularly prudent at this time."

From the bank to the writer: Dateline: July 9, 1993

" . . . reams of research data accumulated over the years has shown that attempts to consistantly add portfolio value by timing changes in interest rates have been as unsuccessful as timing changes in the stock market."

From the writer to the bank: Dateline: July 14, 1993:

" . . . (But) there is no reason to maintain a .75M investment in fixed income when we do not need the incremental income that such fixed funds (as opposed to equities) generate. I should have mentioned to you that this is the compelling reason why a 75% - 25% fixed vs. equity (split) is not appropriate to our investment objectives at this time. If you wish confirmation from the remaindermen, I would be happy to supply same. However, they are well aware that their interests are better served by a higher equity mix."

From the bank to the writer: Dateline: July 19, 1993

" . . . Since your letter concerned only the investment policy for the account, I have requested that (name deleted), the investment officer for the account, respond directly to you."

From the bank to the writer: Dateline: July 27, 1993

" . . . your expressed lack of need of investment income and desire for long-term capital appreciation is, to a degree, different from many irrevocable trust situations especially considering the fact that you have no access

to principal of the trust . . . In the case of the (name deleted) trust, we are managing in accordance with a strategy that is indeed geared to providing greater principal growth. Our strategy of 75% stocks and 25% bonds is based upon both the desires for future potential versus present income as well as the risk management considerations which are governed, to a large extent, by the trust's likely time horizon of more than twenty years. Specifically, we find that in simulating the possible investment outcomes over such long time frames, the less desirable outcome (usually defined at the .10 confidence level) is actually at its best with an asset mix of 65% to 75% in stocks. Beyond 85%, the risk in stocks begins to over come the higher expected trend returns and the possible low results begin to deteriorate. As you would understand, however, in no case is a negative average annual return for the full period expected. This does not mean that we would not entertain possibly moving the trust's investment strategy to a higher normal commitment to stocks. However, before embarking on such a change, we would like to meet with you and the rest of your family to fully discuss the change and to explore the implications in terms of the possible outcomes and your family's circumstances.

From the writer to the bank: Dateline: July 30, 1993

" . . . Would you please explain in plain English the fifth paragraph beginning with "Specifically, we find" . . . and ending with " . . . full period expected."

From the writer to the bank: Dateline: August 27, 1993

" . . . On July 30, 1993 we wrote to you with three (3) specific questions relating to the investment of (name deleted) funds in the Short Term Ex Fund and the Tax Exempt Fund. We have not yet received a reply despite the fact that it now has been almost four weeks since you received our letter. Do you intend to reply or are you unable to provide responsive answers to our questions?"

From the bank to the writer: Dateline: September 1, 1993

" . . . Simply put, when one invests over long periods of time, the "ups and downs" of the stock market which can occur over short periods tend to cancel themselves out and one is left essentially with more of the long term trend return which stocks offer. In fact, if the time frame is sufficiently long, a portfolio with a fair proportion of stocks actually will have a better low return result on an average annual total return basis than a portfolio with little or no stocks. At some point, in terms of equity commitments, however, the higher absolute level of risk in stocks overcomes the higher trend returns and the low return possibilities worsen. As I indicated in my July 27 letter, that level seems to be around 70% in stocks. In any event I have enclosed a chart which depicts this. Let me again extend my invitation to discuss the matter of the trust's investment policy with your entire family."

From the writer to the bank: Dateline: September 7, 1993

" . . . The 'low' returns are essentially identical over all equity percentages. I think you would be hard pressed to demonstrate that any differences were 'real' (ie. statistically significant to say an .05 confidence level). (Thus) an investment strategy based on expected 'low end' returns in not a) a well rationalized strategy and b) presents significant opportunity costs. While it is understood that volatility ('risk') can 'normally' be expected to increase with an increase in equity percentage, the difference in expected return is obviously so slight as to be inconsequential. . . Putting aside the above considerations, your overall 'strategy' of minimizing 'low end' volatility appears singularly inappropriate in the context of a trust account with a 25 year horizon and one which is not subject to periodic invasions."

From the bank to the writer: Dateline: September 13, 1993

" . . . I am in receipt of your letter of September 7, 1993 in which you raised a number of interesting questions about the structuring of the portfolio in the subject trust. Please permit me to assure you that Mellon Bank, working together with our co-trustee (name deleted) has judiciously invested this portfolio in agreement with standard fiduciary practice."

Comments

1) The co-trustee referenced above is a lawyer who for many years was associated with the Philadelphia law firm of Drinker, Biddle and Reath. Since the trusts inception in 1976, he has taken a fee equivalent to one-quarter of the fee charged by the Mellon Bank. To imply that he and the Mellon Bank having been 'working together' on investment matters is patently ridiculous.

His role, if indeed one exists, is to defend the trust (read bank) if the trust was ever challenged. The co-trustee retired to Flordia a while ago. The name of his replacement has never been disclosed to the writer.

2) The fact bears mentioning that this is the first time in 17 years of correspondence that the bank has ever appeared concerned about the financial welfare of the remainderpersons. Even so, such concern appears misplaced considering the fact that 'growth' must be a universal goal of all remainders and thus hardly bears discussion with same. (In any event, the repeated appeals for a family meeting would be difficult to instrument considering that neither remainder lives in Pennsylvania although this fact may not be known to Mellon.)

3) One wonders whether the bank's failure to provide a coherent, understandable and, most importantly, written explanation of their investment strategy is due to a lack of verbal skills, a reluctance to provide same or worse?

Have you corresponded with your bank recently? Why not share your experience with other HEIRS® members? Names of individuals or banks need not be disclosed.

NEW PUBLICATIONS

(1) The American Bar Association sponsored a forum entitled Do We Need a New Standard for Removal of Trustees and Termination of Trusts at their annual convention in New York City last August. The panel was composed of preeminent trust/estate practitioners as well as scholars whose views will guide future reforms in trust/estate law A copy of their remarks is available through HEIRS® at $15 (to cover transcription and shipping costs).

(2) The beneficiaries' viewpoint on bank administrative practices was presented by the writer at a meeting of the national bank examiners in Washington, D.C. last August at the invitation of Dean Miller, Senior Trust Regulator for the Office of the Controller of the Currency. The paper, entitled Fees Up - Service Down: the Corporate Administration of Irrevocable Trusts Needs an Overhaul, is available free to any HEIRS® member.

HEIRS® SONG

Every organization with a worthwhile purpose needs to sing as it fights the good fight. We close this issue of Fiduciary Fun with the official HEIRS® song which may be sung by any member (whose dues are paid) without fear of copyright infringement!

(sung to the tune of "M is for Mother")

H is for the Holdings that we treasure,
E is for our Earnings – win or lose.
I is for the Income we projected – 'til we saw our banks fees blow a fuse;
R is for the Rates and Yields descending
S is for a guy named Smith, in whom we trust –

Here's to HEIRS®! We're all in this together,
Through thick or thin or jolly upper crust.

The HEIRS® song is courtesy of local member Bobbie Shaffner. In the bargain, we promised to let you know that she does customized jingles for special events or Christmas cards for a very modest fee. She lives in Bala Cynwyd, PA and can be reached at (215) 667-4063. Thanks, Bobbie!

ISBN 0-16-044420-9
90000
9 780160 444203